Friends Provident International

Key person and sole proprietor business protection

Adviser guide

Life changes. Be prepared. Be protected.

All businesses have people who are key to success and profitability.

Many businesses would be severely affected if one of these key people were to suffer a serious illness or die suddenly, as this is likely to lead to problems such as a loss of confidence in the business, withdrawal of credit facilities or the need to recruit or train a replacement.

In extreme circumstances, it could even lead to the insolvency of the business and the possibility of personal liability.

Business protection in the form of life insurance can help businesses protect themselves against these eventualities, and help ensure the continuity of the business.

Such plans are relatively simple to effect and can be a cost-effective way for a business to safeguard its future.

This guide will assist you in:

- identifying areas that could benefit from business protection, and
- effecting a plan with a suitable level of cover.

It also sets out other considerations that need to be taken into account.

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Business protection needs and solutions

Business protection planning helps ensure the continuation of a business by financially compensating it for the death or disability of one or more of their key employees.

A key person is anyone whose death or major illness or disability would have a serious impact on the business' financial status and future profits; they are not necessarily a significant shareholder.

The problems associated with the loss of a key person fall into one of the following four main areas:

- **Loss of profits**
- **Loan protection**
- **Management buy-outs**
- **Sole proprietors**

The following section explains each of these areas in more detail, as well as giving suggestions for appropriate product solutions.

Loss of profits

This is likely to be the main area of concern for the majority of businesses. Any employee who makes a significant contribution to profits is likely to be a key person – for example, a top sales person, a technical expert, a project leader, as well as business directors and executives.

The loss of such a key person can result in a reduction in profits in any of the following ways:

- interruption, or loss, of sales/lack of development of new contracts;
- loss of confidence of existing or new suppliers;.
- loss of competitive edge through innovation or design expertise;
- major projects delayed or not completed;
- additional strain on the remaining managers, as they have to cover for the key person;
- lowering of staff morale, possibly leading to some employees leaving the business;
- potentially large recruitment costs/'head hunting' fees or training costs for a replacement;
- potential insolvency leading to possible personal liability of directors for any outstanding debts.

Some of these situations will affect the business' profitability in the short term, such as an immediate loss of sales, whereas other situations will be more damaging to the business in the medium- to long-term, for example the loss of a technical expert.

Profits will not only be affected by the death of a key person but also if the key person were to suffer from a major illness. A heart attack or disablement may result in a long recuperation period or perhaps never returning to work again.

Product solutions

Life insurance can provide the business with financial compensation for the loss of profits resulting from the death of a key person. This could be in the form of a lump sum to pay recruitment costs and a 'head hunting' fee, for example.

The product most commonly used to provide life cover is term assurance, the duration of which will depend on the individual key person scenario. Where, for example, the key person is a project leader it should be possible to identify how long they will remain in such a role, and a term assurance can be effected for that length of time.

For other types of key person it may not be so easy to identify how long they will remain key to the profitability of the business. A key person may not stay in the same position for a long period as assistants, successors, or other experts may join the business to share the responsibilities and tasks.

It is also possible for a business to effect a policy that combines both life and critical illness cover, paying out a lump sum on death or earlier diagnosis of a serious illness, such as heart attack, stroke or major cancer.

Loan protection

The ability to obtain finance makes all the difference to most businesses. Many of these businesses would be seriously affected if anything were to jeopardise their existing loans or their ability to raise new finance. There are three areas of loan protection to be considered in connection with the loss of a key person.

Commercial loans

The loss of a key person can lead to a business being unable to service any debts and this in turn may cause the lender to call in the loan prematurely. Therefore, when businesses borrow, it is not uncommon for them to be required by the lender to effect appropriate key person cover, to ensure that money will be available to repay the loan. Even if not required by the lender, the business may feel it prudent to effect a plan as 'security'.

Business owners' loan accounts

Business owners sometimes lend money to the business on an unsecured basis, or they simply leave some or all of their net salary/bonus or dividends with the business which acts as a loan. If that business owner were to die or become seriously ill, their family would expect the business to repay the loan account, which could put a strain on the business' finances until they are able to make alternative credit arrangements.

Personal guarantees

It is not unusual for a business owner to give a personal guarantee to a lender against a loan to the business. In effect, the lender obtains a guarantee of repayment from the business and, if that proves insufficient, has the personal guarantee of repayment from the director.

However, if that business owner were to die or become seriously ill, this may lead to not only a loss of profits but also a loss of overall confidence in the business itself. The lender may therefore decide to call in the loan prematurely. If the assets of the business are not sufficient to repay the loan, then the lender could seek to recoup the outstanding balance from the deceased's estate.

Product solutions

The business can effect a life insurance plan to provide a lump sum to repay the loan in the event of the key person's death. It is also possible to take out a policy that combines both life and critical illness cover, paying out a lump sum on death or earlier diagnosis of a specified critical illness or disability to repay the loan.

Management buy-outs

A management buy-out – or similar business restructuring – often depends on one or two key persons obtaining the necessary backing from banks or other institutions, and securing vital contracts with suppliers and buyers. If such a key person were to die during these negotiations, or in the early years of the new business, it may be that the buy-out might not go ahead, or the new business might fail.

Product solutions

The business could effect a life insurance plan to protect itself against the loss of the key person. If the plan is designed to protect the business against loss of profits, the type of plan which should be considered will be as outlined above (see 'Loss of profits').

However, it is likely that the key person will be most prominent in the first few years, and in these circumstances a short-term plan would be the most suitable.

Sole proprietors

Usually, the businesses of sole proprietors contribute directly to the financial well-being of the owner and their family.

Sole proprietors not only face the potential problems of loss of profits, due to the loss of a key employee, and the need for loan protection (see page 4), but also have specific business protection needs. If a sole proprietor dies, the consequences for the business could be catastrophic. The business may fold unless a manager can be appointed, the assets of the business may not be secure and the business may not survive the inevitable financial loss caused by a disruption in trading.

In this situation, it is likely that their family will be required to take over the business. This may be very difficult for them if they have no financial assistance, or lack the relevant business knowledge or skills.

It may not be possible for the business to survive the loss of the sole proprietor. In this case, the business will fold and a liability to make redundancy payments may arise.

Product solutions

The main aim in this situation will be to provide for a lump sum to be payable on the death of the sole proprietor to replace the profit they generated, or to pay off debts, and to ensure continuity of the business in the short term. This lump sum would enable the family to retain or recruit the employees with the necessary skills to keep the business going. The family can then decide whether to involve themselves long term in the running of the business or to sell it as a going concern.

The product most commonly used to provide such a lump sum is term assurance. The duration of the plan will need to reflect the expected period of involvement of the sole proprietor in the business. The lump sum could also be provided by a life or earlier critical illness plan, which will not only pay out on death, but also pays out on the earlier diagnosis of one or more of a range of specified critical illnesses or disability.

Calculating the amount of cover

Determining the sum assured required to protect a key person in any business is an area that will require detailed discussions with the business. The amount of cover must reflect the financial loss the business would be likely to face due to the loss of the key person, and this involves a number of eventualities that may not be straightforward to quantify. For example, the expected profits of the business in the near future.

The business must always be able to justify the amount of cover and show how it arrived at the sum required. The following examples show various ways of arriving at an appropriate sum assured.

Loss of profits

The most straightforward method of calculating an appropriate sum assured is the **multiple of profits** approach, which aims to give an indication of the profits which may be lost due to the death or disability of the key person as follows:

- **Net profit**
  Five times the average net profit for the last two years. This could be increased to say eight to ten times net profit for fast growing businesses.
- **Gross profit**
  Twice the average gross profit over the last two years, increasing to three times for expanding businesses.

The business owners can then consider how much of this profit is attributable to the key person.

Remember that 'gross profit' is generally revenue from sales, less the cost of those sales. 'Net profit' is 'gross profit' less salaries, administration costs, other overheads and any interest payments. In addition, 'net profit' refers to the figure before any tax is deducted.

The advantages of this method are its simplicity and the fact that it tries to measure directly the loss of profits.

A more sophisticated method is the contribution to profits approach, which uses the following formula:

$$\frac{\text{Key person's expected total remuneration}}{\text{total salary bill}} \times \text{gross profits} \times \text{expected total recovery period in years}$$

For example:

If a business has a gross profit of USD 16 million, the key person's total remuneration is USD 250,000, the total salary bill is USD 7 million and the business estimates that it would take four years to recover from the loss of the key person, the calculation of the sum assured would be:

$$\frac{\text{USD } 250{,}000}{\text{USD } 7 \text{ million}} \times \text{USD } 16 \text{ million} \times 4 \text{ years} = \textbf{USD 2,285,714}$$

This method places more emphasis on the link between the key person and business profits, as well as the length of time it might take the business to recover its position. Some adjustment will be needed if the key person was underpaid or overpaid (if near retirement), or if the total salary bill included a large number of low-paid workers.

However, neither of these methods will be appropriate if the business is not in a profit-making situation and the key person has been brought in to try to turn the business around. In this situation, turnover could be substituted for gross profits in the above formula.

The third approach which could be utilised is multiple of remuneration, whereby the key person's total remuneration is multiplied by a figure of up to 10, depending on how great the likely impact of their loss on the business.

This approach is very straightforward and is suitable where the business' main concern is the replacement costs in terms of recruitment and/or training.

The business' report and accounts for the last few years should be helpful when trying to establish an appropriate level of cover for loss of profits.

Loan protection

The amount of cover should equal the amount of the outstanding loan, and if there is more than one key person being covered, the amount of cover should be split between them.

If the amount of debt fluctuates, the cover should be for the average level. It would be helpful to see any loan agreements to help determine the appropriate level of cover.

Management buy-outs

Determining an appropriate sum assured to cover the loss arising on the death of a key person during a management buy-out or similar restructuring is very difficult, as each situation is unique. The business must try to identify how much is at risk from the sudden loss of a key person and the management buy-out business plan will be helpful (see 'Guidance on financial underwriting' on the next page).

Sole proprietors

The level of cover required can vary considerably, but the assessment of what is required to maintain the business may be easier to gauge than in a larger business. The family will need sufficient funds to either assist with the continuation of the business, or to be compensated for its folding. Any existing life cover for their benefit which could be utilised for either of these purposes needs to be taken into account. As a minimum, where there is a likelihood that the business may be faced with redundancy payments, that liability should be accounted for when determining the level of cover required.

Guidance on financial underwriting

The amount and duration of cover arrived at for business protection purposes must be justifiable. The life office's underwriters will need to know who is effecting the plan, its intended purpose and the method used to calculate the amount of cover, in order to ascertain whether the amount and type of cover is reasonable in relation to the business' particular circumstances.

For larger amounts of cover, where higher sums assured are at risk, underwriters require more detailed information about why the cover is being effected, and a financial underwriting questionnaire will be required. Further documentary evidence may be required to support the application such as:

- business reports and accounts;
- business plan for new businesses and management buy-outs or similar restructurings – this is the key document that is produced to support the raising of finance for the new venture and should include the business' trading projections and share prospectus (where appropriate);
- loan agreement – documents the terms of a loan.

Effecting the plan

Business protection plans for key person cover are relatively simple to effect. With the exception of cover effected by sole proprietors on their own lives, and some partnerships, cover for all the other key person scenarios in this guide will usually be written on a 'life of another' basis, with the key person being the life assured and the business being the applicant and owner of the plan.

No trust or other document is required and, in the event of the death of the key person, the sum assured will be payable directly to the business. Likewise, any sum insured payable on the diagnosis of a critical illness or disability, would be payable to the business.

In order to effect key person cover on this basis it is important to note that the business must have the legal capacity to effect such a plan. Partnerships may not have the capacity to contract in this way, and so would not be able to effect this kind of key person plan on the life of one of their key employees. The partnership may however be able to obtain suitable cover by the key individual effecting a plan on his own life for the benefit of the surviving partners.

Once the business has decided to effect a key person plan it should arrange for a board resolution to be passed, if necessary, so as to officially record its intentions in the minutes of a board meeting.

When the business has decided on the type and amount of cover it wishes to effect the application can be submitted. On the application form the key person will complete the sections on personal and medical history, while the business will provide details on the reason for the plan being effected and any more detailed financial underwriting information that may be required (see 'Guidance on financial underwriting'). An authorised official, such as a director or company secretary, should sign these documents on behalf of the business.

If the plan has been effected in conjunction with a loan, the lender may require the plan to be assigned to them.

Where the plan is being effected by a sole proprietor the way the cover is to be arranged depends on its purpose as follows:

- **Key employee** – sole proprietor effects the plan on the life of the key employee.
- **Loan protection** – sole proprietor will usually effect an own life plan which may subsequently be assigned to the lender.
- **Provision for dependants to continue the business** – sole proprietor will effect an own life plan written under a suitable trust or nomination for the benefit of the dependants.

What happens when a key person dies, leaves or retires?

Key person dies

In the event of the key person's death, the business will claim the sum assured payable under the plan. This will be in the form of a lump sum. Often, the business will need to apply the proceeds as it originally intended when it took the plan out to compensate for a loss of profits, repay a loan, or recruit a replacement, for example.

In other circumstances the business may have more freedom in how it uses the proceeds such as:

- Top up the key person's death in service benefits to the maximum allowable.
- Additional pension contributions in respect of other directors/employees.
- Repaying additional loans or directors' loan accounts.
- Buying the deceased's shares, if the deceased was a shareholder of the business, if this is allowed.

If the key person plan was assigned to a lender as collateral for a loan, then the outstanding loan would have to be repaid before the business could apply any excess proceeds as above.

Key person leaves or retires

If the key person were to leave or retire before the expiry of the life insurance plan, the business has three options:

- Stop paying the premiums and lapse the plan.
- Continue paying the premiums and receive the proceeds should the key person subsequently die during the plan term.
- Assign the plan to the key person for them to continue the plan as personal cover.

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Friends Provident International has over 35 years of international experience and our heritage dates back over 180 years.

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