Insuring The Key People

Skills, knowledge, contacts, experience: these are assets inseparable from their possessors. But what if the person involved dies? Key person insurance provides for the subsequent loss **By Basil Miller**

MORE AND MORE, WE are told the economy is developing as a knowledge economy or a services economy. This emphasises even more the truism that a business's greatest asset is its people, as the skills, knowledge, experience, judgment, contacts and relationships that key workers in a company possess are the true key to its success or failure. This is where key person insurance enters the picture.

If one of these key people were to die suddenly, the company may be threatened by the sudden and permanent loss of that person's skills and experience. The profitability of the company could be interrupted and threatened, for example, by the calling in of bank loans for which the deceased had given a personal guarantee; the reduction or withdrawal of credit facilities by banks or suppliers; repayment to the deceased's estate of any loans to the company by him or her; loss of the individual's management expertise or business contacts, i.e. loss of goodwill; the need to commit resources to recruiting a suitable replacement.

In some cases where the individual has unique experience and expertise, a replacement may simply not be found. Key person insurance provides an immediate lump sum payment on the death of the individual insured. The company can use these funds as it wishes. It could pay off outstanding bank loans, repay any loans made by the individual to the company, recruit a suitable successor, invest the funds, or invest in the business.

What do those in the business of supplying cover have to say about key person insurance? Barry McCutcheon of Hibernian Insurance says his firm pays out regularly on its key person policies. His experience has been that "the smaller the company, the more dependent it is on key people - indeed, it may be completely dependent on one person who is, effectively, the business".

> Quantifying the loss of profits element of the cover is more difficult

Says McCutcheon: "Small and medium firms are most liable to the impact of a death or departure. In any firm with less than ten employees its people are key, and the consequences of loss proportionately greater." McCutcheon believes the surface of the market for key person insurance has barely been scratched, with a penetration rate of only 5% to 10%.

Sheila Burns of Deloitte Pensions and Investments concurs. She thinks it's "strange that more businesses have not got such a cover in place, especially as it can be inexpensive". Adds Burns: "In smaller companies the attributes of one or two people can make the difference between failure and success. These people are the individuals with expert knowledge of their industry, or who have the vital contacts which generate sales or have some form of specialised knowledge (particularly important in high-tech businesses) or they may indeed be the entire HR or marketing team."

Burns says she knows that policies have made a difference to firms that have had to invoke them: "The sum paid in the event of a claim ideally represents a capitalised version of future profits. This capital sum enables the company to trade safely now, in the knowledge that future profits are secure at a time when it needs to readjust its operations and to seek to replace the knowledge and skills of the key employee."

"While we wish not to see claims for this form of insurance, they are made, of course. But it's more perturbing to see companies go under, or suffer severely, due to not having in place a simple and not necessarily expensive solution."

Who To Insure?

A company can insure any director or employee on whom the business depends for its continued success, and whose death could result in the business suffering an interruption of business and financial loss. Loss of profits consequent on the departure from the company of a key employee can also be covered by a policy. A good example here would be cover for a project manager, whose departure to another job might entail the imposition of penalties on the company for failure to complete the project on time. Construction companies, high-tech firms and others would be among those who should consider such a step.

Other circumstances need to be considered too. Any director, any sole

Continued on page 74

> 'In any firm with less than ten employees its people are key, and the consequences of loss proportionately greater'

proprietor, or any family company boss should face the question: Can this business survive my own death? Could it be sold as a going concern? Your spouse/partner or relatives would need a lot of money to pay outstanding loans and keep the business running until they found a buyer or recruited someone to run it. Should you die, the value of your shares (or, if you are a farmer, the value of your land and business) would be included in your estate, and liable to inheritance tax and probate tax. Again, if a major shareholder dies and you are unable to buy the shares, you might find yourself in business with the heirs. This can bring its own difficulties.

How Much Cover?

To decide this, several factors should be taken into account.

Loans The necessity to repay loans on the individual's death. These could be either: loans from the individual to the company, be repayable to their personal representative on death, and where immediate repayment might be demanded; or company loans where the deceased has given a personal guarantee to the lender, which could become repayable on the death of the individual.

Loss of Profits Quantifying the loss of profits element of the cover is more difficult. As a rule of thumb, five to ten times earnings is sometimes used. However, this may not give a true reflection of the worth and careful consideration needs to be given to this, as the company will have to stand by the fact that the amount of cover is a fair reflection of the anticipated loss. This would normally need the input of an accountant.

Consequent Expenses There will be other liabilities arising from a death, or a departure from the firm. The largest will probably be the cost of recruiting a replacement, if this is possible, keeping in mind that the market rate for the job may now be greater than the earnings of the former incumbent.

The Decision

A decision of the directors to take out key person cover should first be resolved, passed and minuted at a board meeting. This shows the intention of the company, to protect itself against financial loss in the event of the death or serious illness of the key person(s).

Taxation

The insurance premium may be tax-deductible against corporation tax, but if it is the proceeds are generally treated as a taxable trading receipt. If the premium is not admissible, then the proceeds would not generally be treated as a taxable trading receipt but as a capital receipt, so they would effectively be received free of tax.

While professional advice should be taken in this area, the Revenue generally regards the premium as allowable if four conditions are fulfilled:

- the insured is an employee of the company
- the insured holds an interest of no more than 15% in the company
- the policy is short-term, which essentially means it does not extend beyond retirement age
- and it covers loss of profits only (not loans or other contingencies).

One device that can limit the impact of a capital tax such as inheritance tax on a company is the use of a trust to hold the insurance policies, but though trusts are flexible the law is complex and professional advice is essential.

Two other forms of related key person insurance are worth knowing about. Co-directors insurance ensures that, on the death of a director, funds are immediately available to the surviving directors to purchase their shareholding. This also ensures, if the level of cover is kept current, that the deceased's estate will immediately receive the market value of the shareholding. It also ensures that the shares do not have to be sold to an 'outsider' at an inappropriate time and that control of the company remains with the existing shareholders.

Partnership insurance allows the partners of a firm to decide and plan beforehand what they would do in the event of any of their deaths, and to place a monetary value on their share of the partnership. This option also ensures that an estate can immediately receive the market value of the deceased partner's share of the firm. BP