Key Person Insurance: Protecting Your Most Valuable Assets

As a business executive, suppose you were to arrive at your desk one morning only to be informed that your key sales manager had died unexpectedly during the night. Have you ever considered how such a turn of events might affect your company? Along with losing a valued member of your management team, you would also be losing the manager's skill, "know-how," and, perhaps, the important business relationships he or she had cultivated over the years.

Navigating the Shoals

Although you can't prevent the sudden and unexpected loss of a critical employee, you can receive compensation through key person insurance. A key person policy covers or "indemnifies" a company against the loss of a valued team member's skill and experience. The proceeds can help provide funds to recruit, hire, and train a replacement; restore lost profits; and reassure customers and lenders that business operations will continue and funds will be available to help repay business loans.

Generally, the company owns the policy, the premiums are not deductible, and the death proceeds are received by the company free of income taxes (although there may be alternative minimum tax (AMT) consequences for businesses organized as C corporations).

Charting a Course

Needless to say, it is not easy placing a value on a key employee. Generally, there are three different approaches to determine the amount of insurance that is necessary.

One of the most common methods is called the "multiple" approach. This method uses a multiple of the key person's total annual compensation, including bonuses and deferred compensation. The disadvantage to this approach is that the estimate, typically for five or more years' annual compensation, may or may not relate to actual needs. The popularity of this method may simply be a reflection of the difficulty business executives have in quantifying a key employee's value.

A more sophisticated method is the business profits approach. This method tries to quantify the portion of the business's net profit that is directly attributable to the efforts of the key person and then multiplies that amount by the number of years it is expected to take for a replacement to become as productive as the insured. For example, if the estimate of net profit attributable to the key employee is $250,000 annually, and it is estimated that it would take five years to hire and train a replacement, then, the policy's face amount would be $1.25 million under this method.

A third method determines the present value of the profit contributions of the key employee over a specified number of years. This quantity is then used as the face amount of the policy. For a simplified example, with anticipated profit contributions of $250,000 per year for the next five years and a discount rate of 8 percent, the policy's face value would be about $1 million. This method assumes the insurance proceeds can be invested at some rate of return and will be expended over a period of years. Business executives should consult with their insurer regarding the company's specific "rule of thumb" approach.

Regardless of which method is best suited for your business, key person insurance is a vital component to consider in protecting your business from the loss of your most valuable assets—the people who help it grow and prosper. In addition to providing cash to recruit, hire, and train replacements, the proceeds can also be used to help restore lost profits, maintain customer satisfaction, and lender obligations.