Keyperson and sole proprietor business protection

Keyperson and sole proprietor business protection

Introduction

All businesses contain people who are key to the success and profitability of the business. Many of these businesses would be severely affected if one of these key people were to die suddenly, leading to problems such as a loss of confidence in the business, withdrawal of credit facilities, the need to recruit or train a replacement. In extreme circumstances, it could even lead to the bankruptcy of the business. In addition, there may be the possibility of personal liability in the event of a business failing.

Business protection in the form of life assurance can help businesses protect themselves against these eventualities and help ensure the continuation of the business. Such plans are relatively simple to effect and can be a cost-effective way for the business to help safeguard its future.

This guide will assist you in

- identifying those areas that could benefit from business protection, and
- effecting the cover provided by such plans.

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

Whilst every care has been taken to ensure the accuracy of the information in this guide, Friends Provident International can accept no liability arising from its use.

For simplicity this brochure is written in the masculine gender but is intended to include the feminine where appropriate.

Friends Provident International does not provide legal, taxation or investment advice. Independent advice relevant to the specific legislation within your country of residence or domicile should be obtained before implementing any of the arrangements outlined in this guide.

For Advisers only. Not for use with customers.

Content

Business protection needs and solutions

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

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

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

- loss of profits
- loan protection
- management buy-outs
- sole proprietors

The following sections explain 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 keyperson – for example, a top salesman, a technical expert, a project leader, as well as business directors and executives. The loss of such a keyperson can result in a reduction in profits in any of the following ways:

The family then has two alternatives:

- interruption, or loss, of sales/lack of development of new contracts
- loss of confidence of existing or new suppliers
- loss of competitive edge afforded by innovative or design expertise
- major projects delayed or not completed
- additional strain on the remaining managers as they have to cover for the keyperson
- lowering of staff morale possibly causing some staff to leave
- potentially large recruitment costs/'head hunting' fee 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 keyperson but also if the keyperson 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 assurance can provide the business with financial compensation for the loss in profits brought about by the death of a keyperson. 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 keyperson scenario. Where, for example, the keyperson is a project leader it should be possible to identify how long he will remain in such a role, effecting a Term Assurance for that period of time.

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

It is also possible for a business 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 critical illness, such as heart attack, stroke or major cancer.

Loan protection

The ability for a business to obtain finance as and when required makes all the difference to most companies. Many of these companies would be seriously affected if anything were to jeopardise their existing loans or their ability to get new loans.

There are three areas of loan protection to be considered in connection with the loss of a keyperson.

- Commercial loans

  The loss of a keyperson can lead to the business being unable to make loan repayments and thus cause the lender to call in the loan prematurely. Therefore, when companies borrow, it is not uncommon for them to be required by the lender to effect appropriate keyperson 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'.

- Directors' loan accounts

  Directors 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 director were to die or become seriously ill his family would expect the business to repay the loan account, which could put a strain on the business' finances until they could seek an alternative credit arrangement.

- Personal guarantees

  It is not uncommon to find that a director has given a personal guarantee to a lender for 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 director were to die or become critically 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 would seek to recoup the balance from the deceased's estate.

Product solutions

The business can effect a life assurance plan to provide a lump sum to repay the loan in the event of the keyperson / director'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

Management buy-outs or other similar business restructurings often depend on one or two keypersons obtaining the necessary backing from the banks or other institutions and securing vital contracts with suppliers and buyers. If such a keyperson 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.

The role of life assurance

The business could effect a life assurance plan to protect itself against the loss of the keyperson. If the plan is designed to protect the business against loss of profits the considerations as to the type of plan will be as outlined above (see 'Loss of profits' section). However, it is likely that the keyperson will be most prominent in the first few years, so 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 his 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 relevant sections above), 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, the family will be the ones required to step in to sort out the business. This may be very difficult for them if they have no financial assistance, or, indeed, the relevant business knowledge or skills.

It may not be possible for the business to survive the loss of the sole proprietor, such was his contribution to its existence. In this case, the business will fold and a desire or 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 help ensure continuation of the business in the short term, until the family have been able to make provisions for the longer term. This lump sum would, for instance, help 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 viable concern.

The product most commonly used to provide such a lump sum is Term Assurance. The term 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 earliercritical illness plan, which will not only pay out on death, but also pays out earlier on the diagnosis of specific critical illnesses or disabilities

Calculating the amount of cover

Arriving at a sum assured to be provided under a Keyperson Plan is an area that will require detailed discussions with the business. The amount of cover must reflect the financial loss the business would face due to the loss of the keyperson 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 and thus the following shows various ways of helping to do this.

Loss of profits

The most straightforward method 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 keyperson as follows:

- **Net profit** – five times the average net profit for the last three years. This could be increased to, say, eight to ten times for fast expanding companies.
- **Gross profit** – twice the average gross profit over the last three years, increasing to three times for expanding companies.

Remember that 'gross profit' is generally revenue from sales less the cost of those sales and 'net profit' is 'gross profit' less salaries, administration costs, other overheads and any interest payments. Also, 'net profit' refers to the figure before 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: keyperson's total expected total remuneration / total salary bill x gross profits x expected total recovery period in years

For example, if a business has a gross profit of USD16 million, the keyperson's total remuneration is USD80,000, the total salary bill is USD7 million and the business estimates that it would take four years to recover from the loss of the keyperson, the estimated sum assured would be:

USD80,000/USD7m x USD16m x 4 years = USD731,428

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

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

The third approach which could be used is the multiple of remuneration approach, whereby the keyperson's total remuneration is calculated and multiplied by a figure of up to ten, depending on how great would be the loss of the keyperson.

Again this approach is very straightforward and would be suitable where the business's main concern would be the replacement costs of recruitment or training. Some adjustment would need to be made once again if the keyperson was either underpaid or overpaid.

The business Report and Accounts for the last few years should be helpful when trying to establish the 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 keyperson being covered, the amount of cover should be split between them. If the amount of credit fluctuates then the cover should be for the average level. Obviously any loan agreement available will be helpful in arriving at the appropriate level of cover.

Management buy-outs

To arrive at a sum assured to cover the loss that would occur on the death of a keyperson during a management buy-out or similar restructuring is very difficult, as each situation is unique. The business must try and identify how much is at risk from the sudden loss of a keyperson and the management buy-out business plan should be helpful here (see 'Guidance on financial underwriting' below).

Sole proprietors

The level of cover required can vary enormously but theassessment 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 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 funded for.

The considerations for the amount of cover under a plan including Critical Illness and Disability Benefit will be similar to those for pure life cover outlined previously.

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 cover, its intended purpose and the method used to calculate the amount, in order to be sure that the amount and type of cover is reasonable in relation to the business's particular circumstances.

For larger amounts of cover, where more is at risk, the underwriters will require more detailed information about why the cover is being effected, as requested on a Financial Underwriting Questionnaire, and may require further documentary evidence to support the application such as:

- business report and accounts
- business plan for new companies 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's trading projections and share prospectus (where appropriate)
- loan agreement – documents the terms of a loan.

Effecting the plan

Business protection plans for keyperson cover are relatively simple to effect. With the exception of cover effected by sole proprietors on their own lives, cover for all the other keyperson scenarios in this guide will usually be written on a 'life of another' basis, with the keyperson 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 keyperson, the sum assured will be payable direct to the business. Likewise, any sum assured payable on the diagnosis of a critical illness or disability, would be payable to the business.

In order to effect keyperson 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 keyperson 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 keyperson 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 the keyperson will complete the sections on personal and medical history, while the business will provide details on why the plan is 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 business secretary, should sign these documents on behalf of the business. Where a director or business secretary is the keyperson on whose life the cover is being effected he should not sign on behalf of the business as well as signing as the life assured.

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 keyperson dies, leaves or retires?

Keyperson dies

In the event of the keyperson's death the business will claim the sum assured payable under the plan. This will be in the form of a lump sum.

Often, of course, 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 cases the business will have more freedom in how it uses the proceeds such as:

- In some circumstances it may be possible to top up the keyperson's death in service benefits to the maximum allowable.
- Making 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 the keyperson plan was assigned to a lender then, of course, the outstanding charge would have to be repaid before the business could apply any excess proceeds as above.

Keyperson leaves or retires

If the keyperson were to leave or retire before the expiry of the keyperson plan, the business has three options:

1 Stop paying the premiums and lapse the plan.

2 Continue paying the premiums and receive a 'windfall' profit should the keyperson subsequently die.

3 Assign the plan to the keyperson for him to continue as personal cover.

£ amounts are shown as US$ equivalents.
US$ Exchange rate used 1.5990

Friends Provident International Limited: Registered and Head Office: Royal Court, Castletown, Isle of Man, British Isles, IM9 1RA.
Telephone: +44 (0)1624 821212 | Fax: +44 (0)1624 824405 | Website: www.fpinternational.com. Isle of Man incorporated company number 11494C.

XPROT/B 01.18