Key Person Life Insurance

Many times the continued success (and sometimes survival) of a business depends upon the active involvement of one or more individuals due to their capital contribution, technical knowledge, talent, customer rapport or other experience. Similar to insurance that indemnifies businesses for property and liability losses, key person life insurance indemnifies the business for losses caused by the death of a person important to the success of the business.

- The key person's death may cause a loss of management skill and experience, which can be particularly devastating for businesses without management depth.
- There may be a disruption in sales or business development, especially when profits are dependent on the key person's relationships with important clients.
- The business may experience credit difficulties, as creditors may hesitate to extend loans or favorable credit terms, particularly if that employee's talents or resources were factors that encouraged the lending institution to extend loans or special terms in the past.
- Hiring and training a replacement for the key person can be expensive. Even if the business can promote from within, business losses may continue to accrue until the replacement becomes thoroughly familiar with the job.
- Sports franchises are particularly exposed to financial losses in the event of the death of a high profile professional athlete.

Key person insurance insures the life of the key person, but the business is the applicant, owner, premium payor and beneficiary. In the event of the key person's death, the policy's death benefit is paid to the business to help it sustain any economic losses that it incurs until a replacement is recruited and trained.

The two basic methods of determining the appropriate amount of key person insurance are: (1) the contribution of earnings method and (2) the cost to replace experience method. Under the first method, the amount of the death benefit proceeds equals the present value of the estimated revenue that the business would lose until a qualified replacement was recruited, trained and properly experienced. Under the second method, the economic value of the insured key person equals the difference between the insured key person's compensation and the salary that would be required to pay someone else to perform the key employee's routine duties, multiplied by the number of years it will take to recruit, train, and bring a replacement to the insured key person's level of experience.