Key Person Insurance

Many times the continued success and sometimes survival of a business is contingent on the active involvement of a certain individual due to his or her capital contribution, technical knowledge, talent, customer rapport or experience. Similar to insurance that indemnifies the business for property and liability losses, life and disability insurance indemnifies the business for losses caused by the death or disability of an important key person.

- The key person's death or disability 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 rapport with important clients.

- The business may experience credit difficulties. 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 or disability of a high profile professional athlete due to the prevalence of multi-million dollar guaranteed contracts.

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 or total disability, the policy's death benefit or a lump-sum disability 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 ke y person insurance are: 1) the contribution of earnings method; and 2) the cost to replace experience method. Under the former approach, the insurance amount 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 later approach, 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.