

Keyperson & Sole Proprietor Business Protection

CONTENTS

Page	
2	Business Protection Needs and Solutions
4	Calculating the Amount of Cover
5	Effecting the Plan
6	When a Keyperson Dies, Leaves or Retires

INTRODUCTION

All businesses contain people who are key to the success and profitability of the company. 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 company, withdrawal of credit facilities, the need to recruit or train a replacement. In extreme circumstances, it could even lead to the bankruptcy of the company. In addition, there may be the possibility of personal liability in the event of a company 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 company 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 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 should be obtained before implementing any of the arrangements outlined in this guide.



BUSINESS PROTECTION NEEDS AND SOLUTIONS

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

A keyperson is anyone whose death or disability would have a serious effect on the company's 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 company directors and executives. The loss of such a keyperson can result in a reduction in profits in any of the following ways:

- 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
- Special 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 company's profitability in the short term, such as an immediate loss of sales, whereas other situations will be more damaging to the company in the medium to long term, for example the loss of a technical expert.

Product Solutions

Life assurance can provide the company 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 Level 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 company, 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.

In addition, if the Policy is for three years or more, Friends Provident International will automatically include Terminal Illness Benefit free of charge. This will pay out a sum equal to the Guaranteed Death Benefit and helps cover the business over any difficult time associated with such a diagnosis for the keyperson.

Loan Protection

The ability for a company to obtain finance as and when required makes all the difference to most companies. Most of these 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 company 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 company may feel it prudent to effect a plan as 'security'.

- **Directors' loan accounts**

Directors sometimes lend money to the company on an unsecured basis or they simply leave some or all of their net salary/bonus or dividends with the company which acts as a loan. If that director were to die or become seriously ill his family would expect the company to repay the loan account, which could put a strain on the company's 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 company. In effect, the lender obtains a guarantee of repayment from the company and, if that proves insufficient, has the personal guarantee of repayment from the director. However, if that director were to die or become terminally 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 company are not sufficient to repay the loan then the lender would seek to recoup the balance from the deceased's estate.

The role of Life Assurance

The company can effect a Life Assurance Plan to provide a lump sum to repay the loan in the event of the keyperson / director's death or the diagnosis of a terminal illness.

Where the duration of the loan is known a Term Assurance Plan would normally be suitable.

Management Buy-Outs

Management buy-outs or other similar company restructurings often depend on one of 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 company, it may be that the buy-out might not go ahead.

The role of Life Assurance

The company could effect a Life Assurance Plan to protect itself against the loss of the keyperson. If the plan is designed to protect the company 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.

However, 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.

The role of Life Assurance

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 inclusion of free Terminal Illness Benefit, as outlined in the 'Loss of Profits' section may be especially valuable in the Sole Proprietor scenario, where payment of the sum assured at such a time could help a small or family-run business.

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 company. 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:

$$\frac{\text{keyperson's total remuneration}}{\text{total salary bill}} \times \text{gross profits} \times \text{expected total recovery period in years}$$

For example, if a company has a gross profit of £10 million, the keyperson's total remuneration is £50,000, the total salary bill is £4 million and the company estimates that it would take four years to recover from the loss of the keyperson, the estimated sum assured would be:

$$\frac{£50,000}{£4m} \times £10m \times 4 \text{ years} = £500,000$$

This method places more emphasis on the link between the keyperson and company profits as well as the length of time it might take the company 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 company is not in a profit making situation and the keyperson has been brought in to try and turn the company around. In this situation company 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 company'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 company 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 company 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' on page 5).

Sole Proprietors

The level of cover required can vary enormously but the assessment of what is required to maintain the business may be easier to gauge than in a larger company.

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.

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 company'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:

- Company 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 company'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 be written on a 'life of another' basis, with the keyperson being the life assured and the company being the applicant and owner of the plan. No trust document is required and, in the event of the death of the keyperson, the sum assured will be payable direct to the company.

In order to effect keyperson cover on this basis it is important to note that the company 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 in trust for the surviving partners.

Once the company 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 company has decided on the type and amount of cover it wishes to effect the proposal can be submitted. On the proposal the keyperson will complete the sections on personal and medical history, while the company 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 company secretary, should sign these documents on behalf of the company. Where a director or company secretary is the keyperson on whose life the cover is being effected he should not sign on behalf of the company as well 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 dependents to continue the business – sole proprietor will effect an own life plan written under a suitably flexible trust or nomination.

WHAT HAPPENS WHEN A KEYPERSON DIES, LEAVES, OR RETIRES?

Keyperson Dies

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

Often, of course, the company will need to apply the proceeds as it originally intended when it took the plan out to make up for a loss of profits, repay a loan, or recruit a replacement, for example.

In other cases the company 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 company.

If the Keyperson Plan was assigned to a lender then, of course, the outstanding charge would have to be repaid before the company 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 company has four 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.

Friends Provident International is the trading name of Friends Provident Life Assurance Limited for business conducted outside the United Kingdom

Registered and Head Office: Pixham End, Dorking, Surrey RH4 1QA England
Incorporated company limited by shares and registered in England number 782698

Member of the Friends Provident Marketing Group and authorised and regulated in the United Kingdom by the Financial Services Authority
Member of The Association of International Life Offices

Salisbury Office: United Kingdom House, Castle Street, Salisbury, Wiltshire SP1 3SH England
Telephone +44(0) 1722 311611 Fax +44(0) 1722 332005
E-mail fp.int@friendsprovident.co.uk Website www.fpinternational.com

The rules and regulations made by the Financial Services Authority for the protection of investors will not normally apply to persons resident outside the United Kingdom



FRIENDS PROVIDENT
INTERNATIONAL