



KeyPersonInsurance.com
Protecting Your Most Valuable Assets

Key Man Life Insurance: Information You Need to Know



Table of Contents

01	How Does Key Person Life Insurance Work?	Page 3
02	What Type of Policy Should I Consider?	Page 4
03	The Difference Between Key Man Life and Ordinary Life Insurance	Page 6
04	What Type of Businesses Need Key Man Life Insurance?	Page 7
05	Why You Should Consider Buying Key Man Life Insurance	Page 11
06	Key Man Life Insurance Benefits	Page 13
07	How Much Coverage Do You Need?	Page 14
08	Conventional Key Man Valuation Methods	Page 17
09	How Underwriting Works	Page 19
10	How You Can Buy at the Lowest Rate Today	Page 24

How Does Key Person Life Insurance Work?

The basic premise of a key man life insurance policy is rather simple.

1. A business entity purchases a life insurance policy on the life of a key employee, executive, or business owner who is invaluable to the continuation of the business.
2. The business applies for and owns a life insurance policy, pays all premiums, and is the beneficiary in the event of death.
3. At payout, the business generally receives the proceeds of the key man policy tax-free and can use the funds as it so chooses.

To ensure the policy proceeds are received tax-free, all companies should follow the IRS reporting requirements for all business-owned life insurance policies.



What Type of Policy Should I Consider?

In most cases, we recommend an ordinary level-term life insurance policy. The chief reason for term insurance is its low cost. Many organizations needing key man insurance are small businesses with cost concerns, and term life is the cheapest way for a company to protect itself adequately.

A key man term life policy can have a rate guarantee as short as one year. These annual renewable term plans are the absolute lowest priced policies for the first year. However, rates will increase every year the coverage is maintained. In most cases, the need for key man life insurance is more than one year, so these yearly renewable plans are generally not the most cost-effective over time. We caution our clients not to be short-sighted when it comes to price as annual renewable policies can often become more expensive than a ten-year plan within 3-4 years.

A five-year level term may also be available in some cases. However, these policies are rare because ten-year plans are just as inexpensive. The reason is that there just isn't much competition in the five-year level term market as the most competitive key man life companies don't even offer a five-year plan. The truth is, you will probably pay less for a ten-year level term option.

The "sweet spot" for the majority of key man life insurance needs is a ten-year level term policy. Rates are locked-in for a full ten years, and the price provides tremendous value. In business, ten years is like an eternity, as many things can and do change. And, if the need for the coverage is less than the full ten year period, the policy can be dropped anytime without penalty. The price value with the flexibility to adjust makes a ten-year term life insurance plan the most attractive option for most businesses.

There are also more extended level term options, including 15, 20, 25, and 30-year guarantees. The longer the guarantee period, the more expensive the coverage as you have the insurance company "on the hook" for a more extended time. However, in the case of long term notes or succession planning, the key man need can call for more extended guaranteed coverage and, in some cases, permanent or "whole life" insurance.

What Type of Policy Should I Consider? Cont.

Many start-up companies and small businesses who desperately need protection find level term life insurance extremely affordable. For these companies, the decision to buy it is a “no brainer.”

There are also instances when permanent life insurance should be purchased. In business succession planning cases, lifetime guaranteed policies are generally the most cost-effective solution over time. By locking up a rate for “life,” cash can be guaranteed to be accessible for buying out a deceased owner’s equity.

The general rule for buying key man life insurance is to identify the exact reason for the purchase. Once the need is clear, you can lock-in the rate for the period that matches the need. Sounds simple, but many business owners focus too heavily on price alone and end up having to requalify medically ten years out when they should have considered a longer guaranteed plan from the outset.



What is the Difference Between Key Man Life Insurance and Ordinary Life Insurance?

We work with business owners daily, and one of the most common questions asked is, “*what is the difference between a regular life insurance policy and a key man insurance policy?*”

Well, it’s a trick question. The fact is, ordinary life insurance and key man life insurance are identical in terms of how the policies work.

With both life insurance and key man life, the general concept is the same. There is a policy owner who makes premium payments to a life insurance company for the guarantee a specified amount of money, referred to as the death benefit, will be payable to the beneficiary at the death of the insured person.

The most significant difference between life insurance and key man life insurance is in how the policies are structured.

For example, with most ordinary life insurance policies, the policy owner and insured are the same people, and the beneficiary is usually a spouse or other family member. In other words, most individual life insurance policies are purchased by the insured to provide financial security for his/her family or to cover a specific personal need. With key man life insurance, the key employee is the insured, and the business is the policy owner, premium payer, and beneficiary.

If the key person dies, the death benefit is payable to the business and not the key employee’s family.

Keyman life insurance policies are purchased by companies to provide financial security to the business. Proceeds will be for any purpose, but in most cases, businesses use the funds to identify and hire a capable replacement for the deceased employee.

What Type of Businesses Need Key Man Life Insurance?

A wide range of companies need keyman life insurance plans, and for many reasons, but generally is critical for small and medium-sized businesses.

These companies depend on the expertise and talents of a small number of individuals for their success. The death of one of these key employees or executives may well result in the demise of the firm, or, at minimum, catastrophic hurdles to overcome. Examples of businesses who must consider key man life insurance include:

Start-ups

All companies have key employees, but the start-up company, more than any other, relies on the abilities and skills of a select number of people.

Based on past achievements, these business executives, salespeople, and scientists bring instant credibility to a new company. In fact, in many instances, the entire company's success may depend on only one person.

These key people possess unique abilities to raise capital, have established key relationships with suppliers and vendors, hold technical expertise, which is very rare, or own an extraordinary track record of past sales. Whatever the specific case, a start-up company's most valuable asset is likely its key employee(s).

In a start-up company, the death of a key employee will result in significant financial hardship, and many cases result in business failure.

Therefore, having life insurance is critical to protect your company from a catastrophic loss. The costs to secure adequate coverage are negligible when compared to the economic damage caused by the demise of the company.

Why take a chance?

What Type of Businesses Need Key Man Life Insurance? Cont.

Companies Needing to Secure Financing

To get to the next level, most companies rely on financing or investment capital for the cash flow needed to fund expansion or research and development.

To secure these much-needed funds, lenders, as well as investors, will typically require the business to purchase life insurance on their key people.

One of the country's largest lenders to small businesses, the SBA, **requires** keyman insurance, and, in most cases, before funding any small business loan.

Even if life insurance is not a requirement to secure financing, the cost is negligible compared to the added credibility your company will have with your bank or investors.

When attempting to obtain a loan, do not be surprised if the lender's first question is, "does your company have a key man life insurance policy."

Generally, when using a life insurance policy to secure a loan, a **collateral assignment** is utilized, which ensures the bank receives funds to cover the loan balance due in the event a borrower dies.

A collateral assignment is a legal document familiar to all lenders and in effect, is a lien against the policy which guarantees insurance policy proceeds are first payable to the "assignee," in this case, the lender, with the balance of proceeds going to the named beneficiary of the policy.

With a collateral assignment, if the borrower dies, the loan balance is paid off first, satisfying the terms of the loan. The business will receive the remaining insurance proceeds.

What Type of Businesses Need Key Man Life Insurance? Cont.

Niche Businesses

More than any other type of company, key man insurance is crucial to niche businesses.

For example, hedge funds, research, and biomedical firms, companies with exclusive contracts and other businesses with patents and proprietary systems, all rely heavily on the niche expertise of a key employee or business owner.

What happens to the company if one of these niche people dies unexpectedly?

Non-Profits and Churches

Even non-profits are candidates.

The most common non-profit organizations needing life insurance are churches and religious institutions. Churches routinely need to expand as their ministry and congregations grow, creating needs for additional classrooms, a gymnasium, or worship center.

To borrow the funds necessary, many banks will require a life insurance policy on the pastor of the church or their elders. It makes perfect sense as the growth of the church is, in large part, related to the vision of its pastor or minister.

All Other Business Owner Scenarios

Small business owners have multiple needs for key man insurance, including:
Providing **income** to the business to replace the skills and experience one of the company owners

Creating **liquidity** to buy-out a deceased partner or shareholder's family
Providing funds for the successful **transition** of the company when an owner retires
One of the most critical concerns for any business partner or shareholder is the second scenario.

What Type of Businesses Need Key Man Life Insurance? Cont.

In this situation, the last thing any business person wants is to have a deceased partner's spouse or family as their new business partner.

For this reason, smart businesses have prearranged agreements called buy-sell agreements, which include the instructions for what to do in the event of the death of a shareholder or business owner.

In nearly all cases, term life insurance is the most efficient and cost-effective means to fund these agreements.

Keyman life policies can also be a useful tool for business succession planning, like in the third scenario.

In most cases, a large percentage of a business owner's assets are the business itself. In these cases, life insurance with a cash value component can provide the liquidity needed to successfully transition the ownership of the company without a dramatic effect on its earnings ability and cash flow.

Why You Should Consider Buying Key Person Life Insurance

The primary uses include:

- **To provide funds for recruiting and training a replacement key employee.** Replacing a key person is the number one reason to buy a key man life insurance policy. Many companies have at least one employee that possesses unique skills and abilities, which makes it almost impossible to find a substitute. The recruitment process can take considerable time and resources. The proceeds of a key man life policy can make this complicated process less stressful and buy time needed to find the most qualified candidate.
- **To pay expenses while the company stabilizes.** What if an owner of the company passes away unexpectedly? Could the company continue to move ahead? Life insurance provides instant liquidity to meet cash demands for ongoing operations.
- **To secure loans for business growth and expansion.** Cash is critical to help finance opportunities, and banks and other lenders usually want collateral as security. The death of a key person is a real risk to a small company's ability to pay back a loan. Therefore, it is routine for lenders to require key man insurance on any person who is crucial to the viability of the company. In this capacity, it strengthens the company's credit position.
- **To purchase stock from the deceased owner's estate.** A most important use of life insurance is for buying out a deceased partner's equity in the company. For example, let's say there are two equal owners of a manufacturing company with a fair market value of \$4,000,000, and one of the owners dies. This immediately creates two major issues: 1. How does the deceased partner's family get their share of the equity in the company without selling it? 2. How does the surviving owner pay off the deceased owner's family to avoid being in business with them? Establishing a buy-sell agreement funded with life insurance solves this potential "liquidity" problem.

Why You Should Consider Buying Key Person Life Insurance

- **To pay off debt obligations.** Keyman life insurance proceeds can help pay off substantial commitments, such as a loan taken for the purchase of a business or the mortgage for the facilities associated with the company. For example, two dentists purchase an existing practice for \$750,000 and also finance the acquisition of the office building for \$1,200,000. If one of the dentists dies unexpectedly, how would this impact the ability to pay the notes? Keyman insurance can be purchased on each dentist for \$1,950,000 to satisfy 100% of the obligation if one dies effectively.
- **To fund salary continuation arrangements to surviving spouse.** A salary continuation plan is an agreement between an employee and employer, whereby the employer agrees to continue the employee's salary death or disability. The benefits payable are typically a percentage of salary and length of service. Key-person life insurance can provide funds to the company to honor prearranged salary continuation agreements in the event the key person dies.
- **Executive compensation planning.** Retaining employees is crucial to the success of any business. As an incentive, companies routinely offer executive benefits to those most essential to their success. Life insurance with a cash value component can be a desirable perk to any executive. The business can use non-qualified deferred compensation plans to tie them to the company. This concept is known as "golden handcuffs."
- **When transitioning the company to successor owners.**

The Major Benefits of Owning Key Man Life Insurance

Below are just a few of the many advantages of key person insurance you gain from life insurance:

- **Affordability.**
- **Easy to acquire.**
- **Peace of mind.**
- **Choice.** You choose which employee(s) to insure.
- **Tax-free proceeds.** *(as long as IRS guidelines for Corporate Owned Life Insurance (COLI) are satisfied.)*
- **Funding executive compensation plans.**
- **Deferred compensation and executive benefits.**



How Much Coverage Do You Need?

In many cases, it is hard to put an exact monetary value on how important a key person is to a given business.

The goal when valuing a key person for life insurance is to get the correct amount of coverage (not under-insured or over-insured) based on the specific needs of the business.

However, the amount of life insurance you request needs to be closely associated with the real loss to the company if it loses this key person.

The general insurance company guidelines for the amount of keyman insurance available are as follows:

Employees:

For an employee who owns no equity in the business, the maximum amount of coverage a company can buy is ten times the employee's annual income.

EXAMPLE: If the employee earns \$100,000, the maximum amount of life insurance that can be purchased is \$1,000,000.

That does not necessarily mean your business should buy ten times annual income; it's the stated maximum. You may well find 5 to 7 times the employee's yearly salary may be adequate, and there is no reason to have a dime more insurance than you need.

Employees with Equity Ownership:

For an employee of the business who is also an equity owner, the maximum amount of life insurance a company can purchase is ten times income, plus the fair market value of their ownership interest in the business.

How Much Coverage Do You Need? Cont.

The definition of fair market value is what a reasonable person would be willing to pay for the company.

For example, if you own 15% of a business with a fair market value of \$2,000,000, the maximum coverage any insurance company would be willing to write would be \$300,000 for the equity interest plus ten times annual income.

The following are a few examples:

EXAMPLE # 1:

A company wants to cover its top salesperson for \$5,000,000 because they would have a hard time finding a capable replacement if she died.

In this case, if the key person doesn't have equity in the company or at least earn \$500,000, the insurance company will not allow this amount of coverage.

EXAMPLE # 2:

A company is borrowing \$10,000,000 for project expansion, and the business has two partners who are equal owners.

In some cases, lenders may request \$10,000,000 of life insurance for each owner. However, this doesn't necessarily mean the insurance company will be willing to write \$10,000,000 of life insurance on each owner. Specific details will be required by the insurance company to justify the amount requested, including comprehensive financial information on the company and the transaction.

How Much Coverage Do You Need? Cont.

EXAMPLE# 3:

We routinely receive requests for arbitrary amounts of protection pre-determined by an investor.

If a start-up company with very little revenue or assets attempts to purchase \$7,500,000 of life insurance because they have an investor who wants to protect his investment, the insurance company is NOT going to permit this amount of coverage, as it is unreasonable.

No life insurance company will base the amount of key man life insurance allowable on a Pro-Forma projection which may, or may not, come to pass.



Conventional Key Employee Valuation Methods

There are several valuation methods commonly used to determine the proper amount of key person insurance needed.

These valuation methods include:

- The **replacement cost** method
- The **contribution to earnings** method
- The **multiples of income** approach.

A brief explanation of each valuation method follows below:

Replacement Cost Method

The approach bases the amount of key man insurance needed on what it would cost to *replace the key executive*.

The key here is to identify the salary and other ongoing expenses required in hiring, training, and ultimately replacing the key employee. Costs associated with decreased or lost revenue are also a factor when determining a key employee's replacement cost.

Contributions to Earnings Method

The contributions to earnings method is calculated based on the *percentage contribution the key employee makes to the company's bottom line profit*.

For example, a top salesperson in a small business may contribute 50% or more of the sales of the company, directly resulting in half of the company's profits. In this case, multiply the actual value of half of the company's annual profits by the number of years needed to train an equivalent replacement.

Conventional Key Employee Valuation Methods Cont.

Multiples of Income Method

The multiple of income method is the simplest and most common way of determining the value of a key employee.

As previously noted, most life insurance companies use a common multiple of 8-10 times the key person's current annual salary, including benefits, as a general guideline. Of course, depending on the specifics of the position, a higher or lower multiple may be justified.

Insurance companies are not limited to the key man valuation methods discussed above. Each case merits specific consideration, and therefore should be reviewed based on circumstances. Working with a true professional that specializes in key man life insurance will assure the best results.



How Underwriting Works: 5 Steps to Securing Coverage

Underwriting is the process whereby an insurance company gathers all of the required information to formally review and approve an individual for key man life insurance. The following five steps are the general criteria every insurance company will require to assess, approve, and issue a key man life insurance policy.

1. The Application
2. The Medical Exam
3. Final Review
4. Acceptance Signatures and Payment
5. Collateral Assignment

The Initial Application Process

Every insurance company will require a completed application for life insurance. Each company has its specific application questions and forms, and some are more comprehensive than others. Gathering answers to these questions will take some time. A professional advisor can be extremely helpful in simplifying this process.

If a company requires an exam, the application can be in paper form or completed electronically. Many insurance companies offering a no-exam option will allow you to skip some application questions requiring only a brief online application. However, this process will require a 15-20 minute telephone interview.

Included on the form are general questions about the key person such as:

- **name**
- **date of birth**
- **social security number**
- **address**
- **income**
- **employer**

How Underwriting Works: 5 Steps to Securing Coverage Cont.

Insurance companies will also want to know about other things such as:

- **hazardous sports**
- **hobbies**
- **driving record**
- **criminal record**
- **bankruptcy**
- **foreign travel plans**

Depending on the insurance company, some may ask about the specific health details of the key person (others will get this information from the insurance exam). Since the business will own the policy and be the beneficiary, every insurance company will want specific details about the business, too.

Necessary information such as:

- **the exact business name**
- **business address**
- **telephone number**
- **tax id**

Additionally, the type of business entity:

- **Sole Proprietorship**
- **Partnership**
- **Corporation**
- **LLC**

The nature of the business, its inception date, and the type of industry are also required, as not all companies have the same inherent risks. Finally, financial information will always be necessary.

How Underwriting Works: 5 Steps to Securing Coverage Cont.

In most cases:

- **gross sales**
- **assets**
- **liabilities**
- **net worth for the last two years**

For more significant cases, many insurance providers will require tax returns. The insurance companies will ask about the **fair market value** of the business and the number of shareholders and their equity percentages.

Depending on the state, other supplemental forms will be required, such as a policy replacement form, HIV consent, HIPPA Authorization, and Accelerated Benefits. Most every company will require an Employee Consent Form.

Before submission, the application will need to be signed by both the key person (the insured) and a representative of the business as the policy owner (applicant).

IMPORTANT: To get the best results and to have a smooth and efficient underwriting process, it is critical to provide as much detail as possible on the application. Any questions or “gray areas” need to be explicitly addressed to give the underwriter a clear picture of the circumstances. A properly completed form can make a massive difference in the time it takes to get a policy approved as well as the actual rates of the plan.

The Medical Exam

Unless you are applying for a no medical policy, an insurance exam will be required. The insurance exam is a “mini-physical” exam which includes:

- a height and weight measurement
- blood pressure check
- resting heart rate
- a blood and urine specimen
- 12-15 medical questions

How Underwriting Works: 5 Steps to Securing Coverage Cont.

An EKG may also be necessary for older applicants or larger case sizes, or where a previous heart condition is known.

The exam is usually completed in the convenience of the insured's home or office and administered by a Registered Nurse or trained Phlebotomist. If the policy is substantial, the exam may need to be completed by a Physician.

The exam is paid for by the insurance company. The insured person will receive their lab results for free.

The most important part of the exam will be blood and urine results.

Final Review

Once the application is submitted and the exam completed, the insurance company can begin the evaluation process to approve the policy.

This process involves reviewing all of the application and exam material, including lab results.

Routinely, the insurance company will order medical reports from physicians to get specific details of medical conditions and treatment history.

This process may take a couple of weeks, depending upon how quickly doctors and medical facilities respond to the request for records. Working with an experienced agent will make a huge difference in getting the most efficient results.

How Underwriting Works: 5 Steps to Securing Coverage Cont.

Acceptance Signatures and Payment

Once the policy is approved, it is issued and mailed or sent electronically for review and signature. At this point, the only other requirement is a payment to make the policy active.

Collateral Assignment

Once the coverage is in force, if the insurance was purchased to secure a loan, a Collateral Assignment can be submitted to the insurance company.

The Collateral Assignment needs to be signed by the lender, which is the “Assignee” and the policy owner, the “Assignor.”

What if you are unable to Qualify Medically for a Key Man Life Insurance Policy?

In some instances, adverse health or other circumstances may prevent you from qualifying for a traditional key man life insurance policy. If you are uninsurable or even declined for a conventional keyman insurance plan, there may be an alternative. A “Key Man Failure to Survive” policy can effectively work as an ordinary life policy to provide death protection under most circumstances.

Key Man Failure to Survive (FTS) plans provide limited coverage when an individual can not otherwise qualify for a traditional key man life policy. Some examples of cases where Key Man FTS coverage fits include substance abuse history, obesity falling outside traditional underwriting, or short term coverage needs when a new medical condition may have resulted in a decline. In these instances, death protection is available with a specific disease or condition being “excluded.” These policies allow a business to protect a key person from any death that occurs from a non-excluded condition such as an accident or unrelated illness.

A Key Man Failure to Survive policy can be a useful tool for solving key man life insurance risk. It can also be used as a “bridge” to buy time until the key man can locate coverage under standard traditional underwriting. Most agents have no experience with “Failure to Survive” policies, so it is vital to work with a professional

How You Can Buy Today at the Lowest Possible Rates

The following are the exact action steps you need to take to get the best possible results in your search for a key man life insurance policy.

Identify why you are buying coverage.

Think it through carefully.

Recognizing your purpose for buying key man life insurance is likely not “rocket science,” but taking the time to understand what you are trying to accomplish clearly will assure you find the right solution.

Determine how much insurance you need to protect your business.

We’ve given you examples above how to figure this out, but if you are not sure or have questions, call us!

We will take as much time as necessary to help uncover the appropriate amount of insurance you should buy.

Not enough could be detrimental later, and too much is just a waste of money now.

Decide how long you will need to maintain the insurance.

The purpose of the insurance will help you to identify just how long you need to lock-in the rate on the policy.

A 10-year level term plan is by far the most commonly purchased policy. The reason is that it is the cheapest available plan if you need it for more than two years.

However, in many cases, it doesn’t cost much more to get a longer-term plan. We don’t advocate keeping the insurance longer than you need it but don’t be short-sighted.

How You Can Buy Today at the Lowest Possible Rates Cont.

Categorize the health of the key person.

The health of the key person is the most critical factor in determining the price of a key man life insurance policy.

Our experience is invaluable to you, and if you lean on us, we guarantee you the best possible premiums available to you! If you have a health issue, call us first, and we will help you identify your top options.

Disclose potential lifestyle issues.

Sports and hobbies, like scuba diving and foreign travel, are very relevant in calculating your final rate. These “little things” you may think are irrelevant can potentially result in thousands of dollars in unnecessary added costs.

By disclosing this crucial information, an experienced agent can identify the insurance company who will offer you the best price.

Find the right agent.

Working with an experienced agent who represents multiple insurance companies is the only way to know you will find the best key man life insurance policy at the lowest possible rates, period.

That's what *you need to let us help you!*

Work With the Best in the Business

Our name says it all. Since 2002, we have been the dominant online provider in the key man insurance marketplace. Early on, we made a focused commitment to be specialists in the key man life insurance business.

You owe it to yourself to do business with a specialist who has the experience to get you covered!

Since 1994, we have helped tens of thousands of individuals and businesses uncover their best options in life insurance. During this time, we have written well over \$3,000,000,000 of life insurance and key man life insurance.

Our free advice has saved our website visitors and clients millions of dollars collectively. Also, our efforts have helped many avoid headaches and pitfalls and, more importantly, saving valuable time. Why not let us help you uncover your best key man life insurance options?

Don't just take our word for it. Call us today.

