

# CONCEPTually speaking

from the Advanced Sales Unit of  
Manulife's Tax & Estate Planning Group



## **Key Person Insurance – What is the right amount?**

Key person insurance protection involves the use of life insurance to create immediate working capital for a business to meet immediate cash needs and find a replacement in the event of the death of a business owner or key executive.

The business owner and other key executives spend considerable time and effort in acquiring the knowledge, experience, judgment, reputation, relationships and skills that make them valuable to the business. The death of such an individual results in the loss of a key member of the management team and can have a severe financial impact. For example, during the resulting disruption, lenders may curtail credit, creditors may press for immediate payment, debtors may delay making payments, employees and customers may lose confidence, while providing competitors with an opportunity to take advantage of the situation. Life insurance provides the business with funds to meet these potential cash needs. A question we are frequently asked is **“How much Key Person life insurance does my client need?”**

Unfortunately, there is no easy answer to this question. Determining the right amount of key person insurance is not an exact science. Calculations vary from a simple multiple of earnings to detailed calculations that take into account numerous factors. Outlined below are some of the factors to consider and questions to ask your client when trying to determine the amount of key person insurance.

### **Will the loss of the key person affect cash flow?**

Losing a key person with special skills, experience, reputation and/or relationships with customers is likely going to disrupt business operations. These disruptions could affect sales, production or customer service, in turn affecting revenue and cash flow.

- To what extent do you feel the loss of a key person will affect sales or production?
- How long do you expect this disruption will last?

### **How will business credit be affected?**

If the cash flow is affected by the loss of a key person, the business' credit is also likely going to be affected. Uncertainty or loss of confidence by lenders or suppliers may cause them to restrict credit or demand cash payments.

- Will the loss of a key person affect your company's ability to secure credit?
- Is there potential that existing loan repayment terms could change?
- Will suppliers alter credit terms if your company lost a key person?
- Is there any specific debt or bank loan that should be repaid on the death of a key person?

### **Are there going to be training and recruiting costs?**

Unfortunately, finding an immediate replacement with the same qualifications as a deceased owner or key person is seldom possible in small business situations. It is often necessary to look outside of the business to find a replacement, causing delays, disruption and reduced efficiency.

- What is the cost of finding, attracting, hiring and training a replacement?
- Is a temporary replacement needed while finding a permanent replacement?
- How will other employees be affected by the loss?
- Will have to pay more for a replacement with the same skills as your key person?

Asking the right questions is the first step in determining how much key person insurance your client may need. With that said it is also important to understand that once the amount is determined it has to be approved by the life insurance underwriter. At Manulife, we will generally underwrite coverage amounts up to five times the key person's salary. In special situations we may consider more but normally this will not exceed 10 times salary. Be sure to explain in a cover letter how the amount was determined so the underwriter can review your reasoning which could help in exceptional circumstances.

Using life insurance to protect a business from the death of a key employee is a common practice in the business market. It is important to understand that determining the right amount of insurance is not an exact science. In as much as there are needs analysis tools available they really are just a starting point. Helping your client understand the issues and asking the right questions is key in determining how much key person insurance the business may need.

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