

Key Person Insurance: Why It Matters and How Much You Need

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Key person life and disability insurance are often overlooked by employers. Both these policies indemnify a business for the economic loss of a valuable employee due to a disability or a sudden, unexpected death.

Human resource folks are so caught up in providing benefits payable to employees that too often they neglect to protect the business's *most* valuable assets: the highly compensated employees who are the cornerstone of the business!

How to determine what amount of insurance is appropriate to insure these key employees is an open question. The obvious value is the replacement cost to hire a new, equally qualified individual. But this does not take into account the downtime and loss of business productivity that result from losing the key person. If the individual is an integral part of the sales process, company revenues can plummet.

Life Insurance

Generally, the amount of life insurance should be 5 to 15 times the annual salary of the key employee. Sometimes more than this may be needed. The problem is often convincing the life insurance company to issue coverage sufficient for the determined human life value.

In the mid-90s I worked on a case that involved obtaining life and disability insurance for the CEO of a mid-market, 60-year-old manufacturing company. The difficulty was getting him insured at all. He had current medical problems and an adverse health history. After 10 months of challenging underwriting and many declines, I was able to obtain some insurance—not all we wanted, but a significant amount.

The CEO died less than 2 years after the coverage was placed. Beyond the human devastation this created for the employer, his untimely death created an economic mess. The company felt it had to pay several hundred thousand dollars to his family, which was well beyond the sum for which he had been insured. The employer gave up its key person proceeds to the CEO's family. Today the company is doing well. A great deal of that success is attributable to the policy that we had placed. The current management feels that without those insurance proceeds the company would not have survived; it would have paid the money anyway and depleted the corporate treasury.

Disability Insurance

Obtaining key person disability insurance presents an even greater challenge than procuring life insurance coverage. To begin with, there are fewer disability than life insurers. Underwriting can be problematic also. Underwriters often challenge justifying the need for key person coverage beyond any personal disability coverage already in place. Disability insurers are reluctant to offer coverage that exceeds 70% of an executive's income.

To get past the 70% barrier, you often have to use specialty companies and products. Such policies are usually offered to provide coverage over a short time frame—typically 1 to 2 years. At the end of each interval, the insurer requires new underwriting qualification. The pricing on these policies can be high relative to the benefit offered. Still, despite the high price, the protection is often worth it.

The fact is that the need for disability coverage is actuarially greater than the need for life insurance. The odds on becoming disabled are considerably higher than you may think.

- Between the ages of 18 and 65, 3 in every 10 workers will experience an accident or illness that will keep them out of the workplace for 3 months or more, according to the Council for Disability Awareness.
- 1 in 7 workers can expect to be disabled for 5 years or more before retirement, the Council says.

The amount of disability coverage will end up being quite a bit less than what's offered for life insurance, and it usually will not be offered past age 60. With all of these issues facing the writing brokers, this is not a popular subject to bring up to executives and human resource directors. As a result, many corporate executives end up underinsured or not covered at all for key person disability.

Nevertheless, key person disability and key person life insurance are equally essential, so aim to get all the coverage the company needs to cover its losses should a key executive become disabled or die prematurely. You may not always be able to buy as much coverage as you really need, especially on the disability side, but even partial coverage is far better than none at all.

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