HOW COMPANIES CAN USE INSURANCE TO PROTECT AGAINST THE LOSS OF KEY PEOPLE

Deep Impact

By David Choo

As author Jim Collins wrote in his book Good to Great, the old adage that people are your most important asset is wrong. "People are not your most important asset," he reckons, "the right people are."

So if finding the right people is the key function of leaders and managers, finding the right key people is even more crucial. This does not just apply to political appointments but the corporate scene as well. Business is becoming more competitive and complex.

Stories of how one person like a new CEO can achieve a swift turnaround for companies heading south make exciting reading. Conversely, stories of how consistently profitable firms start to decline once they lose a key leader or officer also abound.

It is not my purpose here to talk about how to find the right people or how to keep them – this should be left to the human-resource experts – but it is my intention to talk about how to lessen the financial impact when key people drop dead suddenly and unexpectedly, or suffer a major illness or disability that causes them to stop work suddenly.

FILLING IN THE GAPS

The key word is "suddenly". If we know when a key person is going to be out of action, we can prepare for a replacement in good time. The obvious way to lessen the financial impact of losing a key person is to groom a ready successor in the wings, but this is expensive and most corporations cannot afford to have a double or even an assistant for key positions.

The second way is to have every job defined in detail and all systems and procedures properly worked out and drilled like the army's standard operating procedures, or SOP. This approach has obvious benefits and should be utilised for all jobs that can be standardised and systemised. But jobs that involve decision-making, leadership and creativity are rather subjective and impossible to standardise.

The reality is that in spite of business contingency planning, a sudden loss of the right person in a key position will have a severe financial impact because there is no ready replacement. A new appointee will take a while to perform up to par, and in the meantime the company may suffer a financial loss.

They will have to contend with an absence of leadership during the transition period, along with the potential loss of key customers, a withdrawal of credit facilities (especially if the deceased key person is the main shareholder and guarantor) and the loss of potential new business under negotiation by the key person.

But the problems don't end there. Other important staff members, especially sales

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personnel, loyal to the key person may also resign, while the company may require increased advertising expenses to beat off competitors looking to seize the opportunity to win customers over. And of course there is the cost of recruiting a successor and, perhaps, paying a gratuity to the deceased's family.

When a family breadwinner – a husband or father, for example – dies or is disabled, the solution to the financial crisis that will likely arise is life insurance. Life insurance was invented for this very purpose, in order to protect families. What is not obvious is that through life insurance covering their key people, corporations can secure some compensation for the financial loss suffered.

This simply means that the company takes out a life insurance policy on the life of the key person so that in the event that he or she dies, becomes totally and permanently disabled or is diagnosed with a major terminal disease, there will be compensation paid to the firm. The concept is similar to the family having life insurance to protect the loss of income and other expenses occasioned by the death or disability of the breadwinner.

GETTING THE MESSAGE

You might expect 'key person' insurance to be at least as popular as fire insurance, because the loss of a key person represents the loss of an asset even more important than the factory or office equipment – physical assets are easier to replace than key people. But key person insurance is not as prevalent as it ought to be for three rather weak reasons.

First, not many insurance agents and brokers are familiar with how to go about it, particularly the issue of how to value the key person and the tax treatment of the insurance premiums and proceeds. Accountants and tax consultants differ over the tax treatment. There are also differing views particularly over what products are suitable for key person insurance. This lack of clarity has contributed to uncertainty and the fear of giving wrong advice, and one response is to avoid the matter altogether. This is to be lamented because companies do need this protection.

The second reason for key person insurance not being as prevalent as it should be is the need for the key person to agree to be insured. The question often asked is: What's in it for me? Companies should recognise that the key person's contribution is very important and should be willing to give some benefit to their key people to make them stay and do their best. This could be added to a compensation package, but the tax treatment has to be handled correctly.

The third reason for the relatively low take-up rate is the perception that the risk actually being faced is low. The reality is that the risk of a firm losing their physical assets to fire is less than the risk of losing their key people to death or disability. Indeed, the change of a key person due to resignation often demonstrates the financial impact of such a sudden loss, although you cannot cover this by insurance.

I call these reasons 'weak' because it is actually quite easy to handle them. There are sufficiently good reasons to insure a key person, even if there is doubt over some of the tax advantages. Key people are willing to be insured if they understand the concept and are assured that the company cares for their welfare as well. Decision-maker's perceptions can be changed when they are presented with statistics and confronted with additional risks like terrorism, avian flu and SARS (severe acute respiratory syndrome).

The right people are your most important asset, and they are worth protecting. It is time for shareholders to protect their key people just like banks have been protecting their loans for years. **si**

KEY PEOPLE, KEY QUESTIONS

If you want to find out more about key person insurance and get answers to the following questions then you can email David Choo at davidchoo@promiseland.com.sg.

1. Who qualifies to be a key person? What are the criteria and who decides?
2. How do I qualify the value of a key person for the purpose of key person insurance?
3. What product(s) are recommended?
4. Can the premiums paid be treated as a deductible expense?
5. Will the insurance proceeds be taxable as income?
6. Who will receive the insurance proceeds? If a firm pays a death gratuity to the deceased key person's family, will this payment qualify as an expense? Will the family have to pay income tax for this gratuity?
7. What happens to the insurance policy when any key person leaves the firm?
8. Which insurance company's product is recommended for key person insurance?

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