High Face Key Person Coverage

FINANCIAL JUSTIFICATION

ADVANCED MARKETS

Sometimes it can take a little preparation to help an insurance carrier see the worth of a key person. By understanding what carriers are looking for, and why, it's possible to justify larger key person policies.

For a typical business, which has been in operation many years, acquiring business-owned life insurance on a key employee is relatively easy. The industry standard for determining maximum coverage is up to 10 times the employee's income. If the desired face amount is within that limit, the insurance company's requirement for financial justification is often simple: just complete its business financial supplement. The supplement will disclose the key employee's annual income, any coverage owned on other key employees, and basic company financial values such as assets, liabilities and fair market value.

On the other hand, there are less typical key person cases which present a greater challenge. These are cases requesting a face amount higher than the standard limit which raises the stakes for the carrier underwriter. The underwriter will apply a more critical analysis to the case before accepting the risk for the carrier, and that analysis will require more data than the business financial supplement provides. Here are just a handful of such scenarios which we encounter several times a year – followed by our strategy for maximizing the likelihood of getting the client the desired outcome.

STARTUP COMPANY

A new company is often formed based on the talents of one or two uniquely qualified people – people who are key to expectations for the company's future success. In the case of an owner, it's not unusual for there to be no actual salary to report in the early years of the venture. Even highly talented non-owners are known to accept below-market compensation at a startup in exchange for the opportunity to make much larger sums as the company matures.

VENTURE CAPITAL /PRIVATE EQUITY

Both new and existing companies may seek to fuel their growth by exchanging equity for capital raised by managers or private equity funds. Those investments are made, in large part, based on the fund manager's confidence in the current owner. Sometimes a fund manager will want to use life insurance to hedge against the risk of the owner dying, ideally with the death benefit allowing the fund to exit with the original amount of its investment.

UNDERPAID KEY PERSON

A company does not have to be a startup to have a key employee whose value to the company is not reflected in the amount of compensation they earn. This can happen in a closely held family business where a senior generation leader has already acquired more than enough personal wealth and wants to shift income to the next generation. It can also happen when a company is able to compete nationally based on an employee's unique relationships or talents, but the company's pay scale is based on the local economy, or when a non-profit is led by a talented executive who could earn much more elsewhere but has a passion for the mission.

List of specific documents you may need to gather when appropriate:

1. Business financials (balance sheet and income statement) for at least three years, longer if demonstrating high growth rate
2. Documentation of total compensation, including salary, bonuses, deferred compensation, stock options, etc.
3. Documentation of third-party capital investments
4. Documentation of bank or other third-party loans
5. Buy-sell agreement
6. Formal or informal business appraisals
7. Form 4506-T

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Solving the problem. When the face amount requested for a key person policy falls outside the industry standard income multiple, success requires more than completing a business financial supplement. To secure an underwriter's offer to issue a policy with the desired face, we must address the financial justification challenges the underwriter will face. In our experience, having a plan goes a long way to obtaining successful outcomes, a plan that includes many of the following:

1. **Engage the right insurance companies.** Consumers often assume that life insurance is a commodity product – especially in the case of term insurance which is often the product type of choice in the context of key person coverage. The reality is that insurance carriers vary quite a bit in terms of underwriting. Most carriers adhere fairly rigidly to published guidelines with respect to financial justification of business-owned coverage. A handful of carriers have underwriters with a more sophisticated understanding of business financials and offer more liberal multiples and unpublished guidelines giving them a competitive advantage for individual consideration.

2. **Tell the right story.** Ultimately, the underwriter's question is, "Does the amount of coverage requested make sense?" Our job is to show that the company has a need for the large face amount, and the best way to do that is to develop a clear, concise story backed up with relevant facts. Ideally, the initial presentation will provide everything the underwriter requires to make a favorable decision. If the underwriter does ask for additional information, it is critically important that the answers provided are accurate and consistent with the overall narrative already established.

3. **Get informal approval prior to formal submission.** The worst time to learn that the carrier underwriter is unwilling to offer the full face amount requested is *after* a formal application has been submitted. Instead, we want to collect the information and documentation to support the desired face amount ahead of time and present it informally to the underwriter. In some cases, we will first engage the carrier's advanced markets team for their advice on positioning the case.

4. **Demonstrate management team's experience and expertise.** Even though the company itself does not have a profitable history, the people running the business often have a history of success at prior companies. Gather all the information you can about their histories and be as specific as possible. For instance, "Tom Jones was previously the General Manager at ABC Logistics. While under his management the company's profitability tripled over a 10-year period." Not only will this information bolster the idea that the new business will be successful, but it also sets up the possibility that the key person's current income is below market value.

5. **Show true value of employee to the business.** If an employee is accepting a low current salary in anticipation of future rewards, documenting the employee's earnings prior to joining the company can help establish the employee's true market value. Current responsibilities and specialized skills should be noted. Providing salary comparisons for the same role at similar companies will also help..

6. **Explain why the company anticipates success.** Explain why the product or service will be a success and will find a profitable niche in the market. Include existing and pending contract details. For companies looking for equity investors, the founders may have prepared an "investor pitch book" which would also be useful to the underwriter.

7. **Share forward looking profitability projections.** Startup firms – especially those with outside investors – often have created a pro forma or other estimate of financial results showing anticipated future growth and profitability. When possible, include details of where the initial capitalization came from because the reputation of an established and sophisticated investor will add credibility.

ASH ANSWERS.

Ash Answers with our Advanced Sales, Underwriting and Case Management Teams collaborating to optimize your unique opportunities by leveraging our expertise, resources and carrier partnerships.

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