Friends Provident International

Who is vital to the success of your business?

All businesses have people who are key to their success and profitability. But what would happen to your business if a key employee were to die or become critically ill? The resultant cost to your business could be devastating without a protection plan from Friends Provident International.

Business protection planning helps ensure the continuation of a business by financially compensating it for the death or disability of one or more of its key employees. This may be a top salesperson, a technical expert, a project leader, as well as business directors and executives. The problems associated with the loss of a key person fall into one or more of the following four main areas:

1. **Loss of profits**
2. **Loan protection**
3. **Management buy-outs**
4. **Sole proprietors**

So, let's delve into these potential possibilities, the suggestions for the appropriate product solutions and the process of calculating the amount of cover.

1. Loss of profits

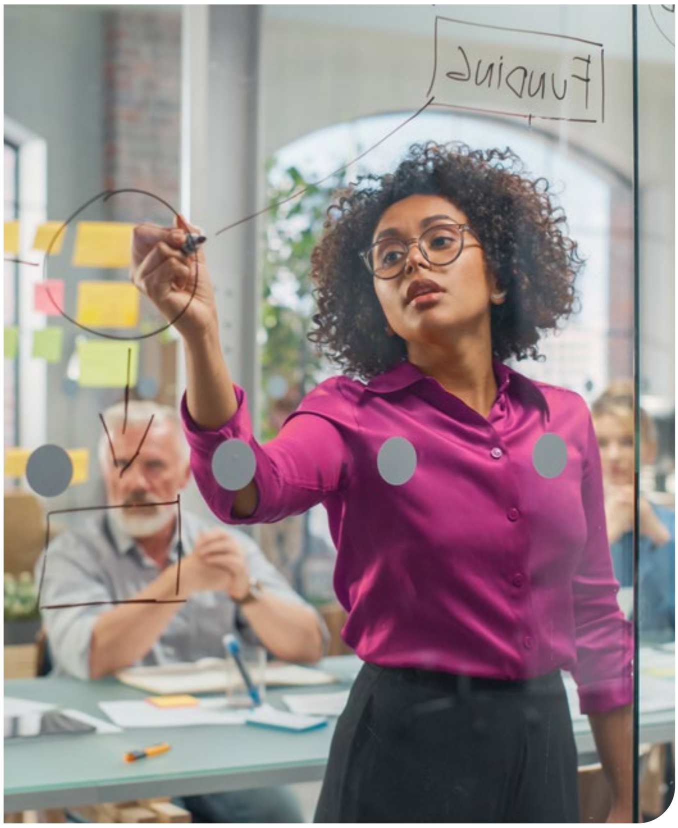
For the majority of businesses, their leading cause for concern is the loss of profits from an employee who creates a substantial contribution – the loss of such a key person can result in the reduction of earnings in any of the following ways:

- Loss of confidence in existing or new suppliers.
- Significant projects are delayed or incomplete, which strains the remaining manager's resources as they cover for the key person.
- Potential insolvency leading to possible personal liability of directors for any outstanding debts.
- Interruption, or loss of, sales/lack of development of new contracts.

Some of these above situations will affect the business's profitability in the short term, such as immediate loss of sales. In contrast, other situations will be more damaging to the business in the medium to long term.

Product solutions

Life insurance can provide the business with the loss of profits resulting from the death of a key person. Term assurance is commonly used to provide life cover, with the duration depending on the individual scenario. A policy combining life and critical illness cover is also possible, paying out a lump sum on death or earlier diagnosis of a serious illness.



Calculating the amount of cover

The most straightforward method of calculating an appropriate sum assured is the multiple of profits approach, which aims to indicate the profits which may be lost due to the death or disability of the key person as follows:

Net profit

Five times the average net profit for the last two years. This could be increased to eight to ten times net profit for fast growing businesses.

Gross profit

Twice the average gross profit over the last two years, increasing to three times for expanding businesses.

The business owners can then consider how much of this profit is attributable to the key person. The advantages of this method are its simplicity and the fact that it tries to measure directly the loss of profits.

A more sophisticated method is the contribution to profits approach, which uses the following formula:

$$\frac{\text{Key person's expected total remuneration}}{\text{total salary bill}} \times \text{gross profits} \times \text{expected total recovery period in years}$$

This method places more emphasis on the link between the key person and business profits, as well as the length of time it might take the business to recover its position. Some adjustment will be needed if the key person was underpaid or overpaid (if near retirement), or if the total salary bill included a large number of low-paid workers.

However, neither of these methods will be appropriate if the business is not in a profit-making situation and the key person has been brought in to try to turn the business around. In this situation, turnover could be substituted for gross profits in the above formula.

The third approach which could be utilised is multiple of remuneration, whereby the key person's total remuneration is multiplied by a figure of up to 10, depending on how great the likely impact of their loss on the business. This approach is very straightforward and is suitable where the business' main concern is the replacement costs in terms of recruitment and/or training.

The business' report and accounts for the last few years should be helpful when trying to establish an appropriate level of cover for loss of profits.

2. Loan protection

The ability to obtain finance makes all the difference to most businesses. Many of these businesses would be seriously affected if anything were to jeopardise their existing loans or their ability to raise new finance. Let's follow onto the three areas of loan protection to be considered in connection with the loss of a key person:

> Commercial loans

The loss of a key person can lead to a business being unable to service any debts and this in turn may cause the lender to call in the loan prematurely. Therefore, when businesses borrow, it is not uncommon for them to be required by the lender to effect appropriate key person cover, to ensure that money will be available to repay the loan. Even if not required by the lender, the business may feel it prudent to effect a plan as 'security'.

> Business owners' loan accounts

Business owners sometimes lend money to the business on an unsecured basis, or they simply leave some or all of their net salary/bonus or dividends with the business which acts as a loan. If that business owner were to die or become seriously ill, their family would expect the business to repay the loan account, which could put a strain on the business' finances until they are able to make alternative credit arrangements.

> Personal guarantees

It is not unusual for a business owner to give a personal guarantee to a lender against a loan to the business. In effect, the lender obtains a guarantee of repayment from the business and, if that proves insufficient, has the personal guarantee of repayment from the director.

However, if that business owner were to die or become seriously ill, this may lead to not only a loss of profits but also a loss of overall confidence in the business itself. The lender

may therefore decide to call in the loan prematurely. If the assets of the business are not sufficient to repay the loan, then the lender could seek to recoup the outstanding balance from the deceased's estate.

Product solutions

The business can affect a life insurance plan to provide a lump sum to repay the loan in the event of the key person's death. It is also possible to take out a policy combining life and critical illness cover, paying out a lump sum on death or earlier diagnosis of a specified critical illness or disability to repay the loan.

Calculating the amount of cover

The amount of cover should equal the amount of the outstanding loan, and if more than one key person is being covered, the amount of cover should be split between them.

If the amount of debt fluctuates, the cover should be for the average level. It is important to see any loan agreements to help determine the appropriate level of cover.

3. Management buy outs

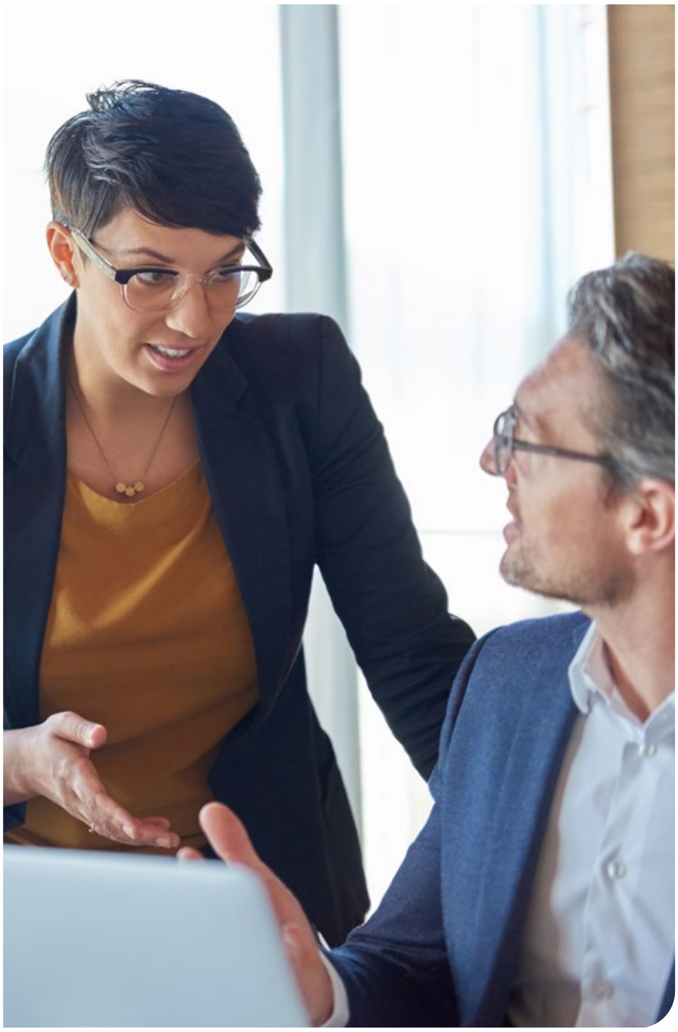
A management buy-out, or similar business restructuring often depends on one or two key persons obtaining necessary financial backing, as well as securing vital contracts with suppliers and buyers. If such a key person were to die during these negotiations, or in the early years of the new business, the buy-out might not go ahead, or the new business might fail.

Product solutions

It is likely that the key person would be most prominent in the first few years of a management buy-out or company restructure. Therefore, the business could effect a short-term life insurance plan to protect itself against the loss of the key person, especially if the plan is designed to protect the business against loss of profits.

Calculating the amount of cover

Determining an appropriate sum assured to cover the loss arising on the death of a key person during a management buy-out or similar restructuring is very difficult, as each situation is unique. The business must try to identify how much is at risk from the sudden loss of a key person and the management buy-out business plan will be helpful.



4. Sole proprietors

A sole proprietor's death can have devastating consequences for the business, including the potential loss of assets and financial instability. However, appointing a manager can help to minimise the disruption in trading, in this situation it is usually a family member which will take over the business. This may be very difficult for them if they have no financial assistance, or lack the relevant business knowledge or skills. The business may not survive the loss of the sole proprietor, in this case, the business will fold and a liability to make redundancy payments may arise.

Product solutions

The main aim in this situation will be to provide for a lump sum to be payable on the death of the sole proprietor to replace the profit they generated, or to pay off debts, and to ensure continuity of the business in the short term. This lump sum would enable the family to retain or recruit the employees with the necessary skills to keep the business going. The family can then decide whether to involve themselves long term in the running of the business or to sell it as a going concern.

The duration of the plan will need to reflect the expected period of involvement of the sole proprietor in the business. The lump sum could also be provided by a life or earlier critical illness plan, which will not only pay out on death, but also pays out on the earlier diagnosis of one or more of a range of specified critical illnesses or disability.

Calculating the amount of cover

The level of cover required can vary considerably, but the assessment of what is required to maintain the business may be easier to gauge than in a larger business. The family will need sufficient funds to either assist with the continuation of the business, or to be compensated for its folding. Any existing life cover for their benefit which could be utilised for either of these purposes needs to be taken into account. As a minimum, where there is a likelihood that the business may be faced with redundancy payments, that liability should be accounted for when determining the level of cover required.

Guidance on financial underwriting

The amount and duration of cover arrived at for business protection purposes must be justifiable. The life office's underwriters will need to know who is effecting the plan, its intended purpose and the method used to calculate the amount of cover, in order to ascertain whether the amount and type of cover is reasonable in relation to the business' particular circumstances.

For larger amounts of cover, where higher sums assured are at risk, underwriters require more detailed information about why the cover is being effected, and a financial underwriting questionnaire will be required. Further documentary evidence may also be required to support the application such as:

- Business reports and accounts.
- Business plan for new businesses and management buy-outs or similar – this is the key document that is produced to support the raising of finance for the new venture and should include the business' trading projections and share prospectus (where appropriate).
- Loan agreement – documents the terms of a loan.

Effecting the plan

Business protection plans for key person cover are relatively simple to effect. With the exception of cover effected by sole proprietors on their own lives, and some partnerships, cover for all the other key person scenarios in this guide will usually be written on a 'life of another' basis, with the key person being the life assured and the business being the applicant and owner of the plan.

No trust or other document is required and, in the event of the death of the key person, the sum assured will be payable directly to the business. Likewise, any sum insured payable on the diagnosis of a critical illness or disability, would be payable to the business.

In order to effect key person cover on this basis it is important to note that the business must have the legal capacity to effect such a plan. Partnerships may not have the capacity to contract in this way, and so would not be able to effect this kind of key person plan on the life of one of their key employees. The partnership may however be able to obtain suitable cover by the key individual effecting a plan on his own life for the benefit of the surviving partners.

Once the business has decided to effect a key person plan it should arrange for a board resolution to be passed, if necessary, so as to officially record its intentions in the minutes of a board meeting.

When the business has decided on the type and amount of cover it wishes to effect the application can be submitted. On the application form the key person will complete the sections on personal and medical history, while the business will provide details on the reason for the plan being effected and any more detailed financial underwriting information that may be required.

An authorised official, such as a director or company secretary, should sign these documents on behalf of the business.

If the plan has been effected in conjunction with a loan, the lender may require the plan to be assigned to them.

What happens when a key person dies, leaves or retires?

In the event of the key person's death, the business will claim the lump sum assured payable under the plan. Often, the business will need to apply the proceeds as it originally intended when it took the plan out to compensate for a loss of profits, repay a loan, or recruit a replacement.

In other circumstances the business may have more freedom in how it uses the proceeds such as:

- Top up the key person's death in service benefits to the maximum allowable.
- Additional pension contributions in respect of other directors/employees.
- Repaying additional loans or directors' loan accounts.
- Buying the deceased's shares, if the deceased was a shareholder of the business, if this is allowed.

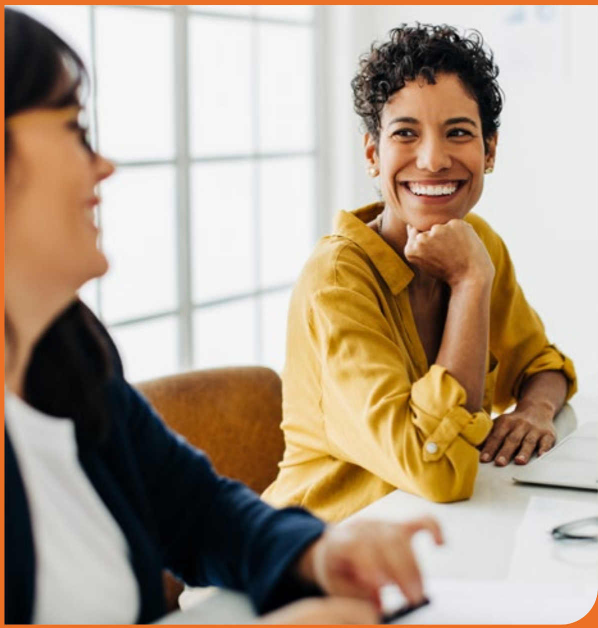
If the key person plan was assigned to a lender as collateral for a loan, then the outstanding loan would have to be repaid before the business could apply any excess proceeds as above.

If the key person were to leave or retire before the expiry of the life insurance plan, the business has two options, stop paying the premium and lapse the plan, or assign the plan to the key person for them to continue the plan as personal cover.

In our experience, many businesses would be severely affected if someone key to them were to suffer a serious illness or die suddenly.

Life insurance has helped many business owners around the world to protect their business against these eventualities. They have often found it a simple and cost effective solution to help ensure the continuity of their businesses, providing peace of mind to them, their families and colleagues.

Steps to insure the key people in your business



01 Identify and qualifying needs

Identify who is the key to the success of your business

02 Application

Complete the application form with your adviser for the protection you have agreed on

03 Acceptance

Once we have all the information we need we will confirm if your application has been successful

04 Review

Ensure that you review your arrangements with your adviser on a regular basis in case your situation changes

At Friends Provident International, we have a range of protection products to help mitigate the risk to your business if a key person were to die or become seriously ill. Speak to your financial adviser for more details or visit www.fpinternational.com