Definition of keyperson cover, and positioning cover with businesses

Synopsis: Keyperson cover and how to position it with businesses.

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The term 'keyman/keyperson assurance' is often used to describe a life assurance policy (which could include a policy providing critical illness cover or income protection) taken out by a company on the life of one of its employees or directors.

There is no legislative definition of such policies or any reference to keyman or keyperson policies in any statutory regulations or case law. The term is effectively a well-established piece of life assurance industry terminology.

These days it is generally recognised that when considering a small privately owned business (as opposed to an international public corporation, or a large professional partnership which may comprise as many as a couple of hundred partners) the primary keypersons in such businesses would be the business owners, i.e. working directors who will normally also be shareholders in a private company, or partners in a partnership or members of a Limited Liability Partnership (LLP).

Of course, regardless of the type of business, employees with specialist knowledge or skills could also be keypersons.

In practice, such employed keypersons are less likely to be encountered in small partnerships. However, in large professional partnerships it may well be that, as well as the partners, some of the firm’s employees could be keypersons. Particular attention also needs to be given to “salaried” partners, who although referred to as partners (and in practice in due course would often be offered an equity interest in the firm) are in reality employees of the firm.

It is important to remember that a partnership in England is not a legal entity, i.e. it cannot contract in its own name and so cannot effect life assurance policies in its own name. Any attempt to do so would be construed as a policy owned jointly by the individual members (not the partnership). Since 6 April 2001 it has, however, been possible for any partnership, including professional partnerships, to incorporate as a LLP.

Although a LLP is taxed as though it is a partnership, it is in law a ´body corporate´ with a separate legal personality from that of its owners who are called members. This means that, unlike a conventional partnership, a LLP can enter into contracts and hold property in its own right. This means a LLP can take out policies in the name of the firm on the lives of the keypersons (employees or members).

The position in Scotland is that a partnership is a legal entity, so policies can be effected by the firm on the lives of the keypersons, be those persons partners or employees.

Arguably, a sole trader is the most 'key' of keypersons in that their death or critical illness is likely to cause serious financial damage to the financial wellbeing of themselves and their family.

On the death of an employee or director the proceeds will be paid directly to the business or company; on the death of a partner in a partnership the proceeds will be paid to the other partners, usually via a suitable trust; and on the death of a sole trader the proceeds will be paid to the sole trader’s family, or if the business is going to continue, to those who will be continuing the business, again usually via a suitable trust.

The position of the individual within the business, e.g. whether an employee with no, or only a small shareholding, or a director with a substantial shareholding or partner/member of a LLP, will not only determine the different methods by which the cover can be effected, but will also affect the tax treatment of both premiums in respect of such policies and the policy benefits.

Positioning keyperson cover with businesses

While an understanding of the technical details (especially the tax and legal implications) of keyperson insurance is an important part of writing high quality business, it is first necessary to create interest in the subject. This can usually most effectively be done by creating "justifiable anxiety". Success in moving keyperson onto the agenda may be more effectively achieved by a more formalised, differentiated approach founded on the offer of a "liability audit" or a "financial risk assessment".

In carrying this out you will be focusing on the need for liquidity on the death or critical illness of the identified keyperson. The recommended approach is to draw up a checklist of ‘reasons why’ funds may be needed on either of these occasions. These ‘reasons why’ will include...

1. Loan repayment;
2. Profit replacement;
3. Cost of recruitment of a suitable replacement;
4. Providing training to existing members of staff;
5. Repayment of directors’ loan accounts, or partners’ capital and loan accounts.

In addition, as a separate financial need, there may be a need for cash to provide for the purchase of a shareholding, or a partnership interest, on the death or critical illness of a shareholder or partner.

There are, of course, many issues to consider in determining how the policies should be written and the resulting tax and legal implications. This is particularly so when the key person is a business owner - as, in most small businesses, they are likely to be.

It is a classic area for advice. Assuming that the necessary understanding is in place to give this advice there is potential for significant payback from an approach founded on offering a "liability audit".

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