EQUITABLE

Underwriting uncovered

Tips on preparing your cases for financial underwriting

Advanced Markets

Key person

Business clients may sustain substantial economic loss upon the death of a key person whether it is an owner, partner or non-owner employee. Generally, these individuals have specialized talents, skills or unique experience critical to business operations. Businesses need a source of funds for protection in the event of such a key person loss. Key person life insurance provides a business with the liquidity it needs upon the death of a key person along with flexibility in funding and access to cash surrender values.

Knowing in advance what Equitable requires when underwriting a key person case allows financial professionals to proactively approach businesses with an appropriate strategy.

Key person cases should include a cover letter that describes:

- Who is covered, including details on the role as a key contributor and annual compensation
- The formula for determining the coverage amount
- What, if any, valuation approaches were used aside from multiple of salary
- Type of business, years in operation

There are a number of additional factors that may be considered in determining the potential key person loss.

Note that businesses may need to provide financial data, including:

- Gross and net earnings for multiple accounting periods
- Key persons' salaries, bonuses and their contributions to accounts or business initiatives
- Evidence of loans requiring key person insurance to secure or partially back the loans
- Evidence of costs of recruiting if it was part of the calculation of the key persons' needs

Multiple considerations

See below for details on the general rule and considerations for a greater multiple or key person valuation.[1]

Amount qualified for key person[2]		Sample calculation
General rule multiple of salary A reasonable multiple of the key person's annual compensation (includes salary, commission and bonus). Without other factors, this is often the default method.	Maximum 10x Annual compensation	**Key person's annual compensation includes:** Base salary $100,000 Bonus $20,000 Commission $30,000 Annual compensation $150,000 Max coverage $150,000 x 10 = $1,500,000
Higher multiple or valuation A greater valuation may be accepted where the underwriter determines the supporting evidence justifies the amount.	**See table of alternative valuation approaches** • A track record of reasonable business success (i.e., sustained annual revenue growth) • Detail on the key person's specialized talents, skills or unique experience	**Key person (KP)** annual compensation is $150,000. The business has been consistently growing for the past 5 years, and KP is key to that growth with highly specialized experience in their niche technology market. Finding a replacement would be very expensive, and bringing that person to KP's level would take years. Given that KP is directly responsible for business growth and the additional replacement factors, they seek coverage of $2,000,000, an amount $500,000 in excess of the 10x income multiple. After review of the business and receipt of details on KP's experience, the $2,000,000 was found to be justified.

Table of alternative valuation approaches

Valuation Approach	Description
Multiple of salary	The value of the key person is based on a multiple of earnings. This value can be determined with their earnings with or without any bonus. The multiple is generally between five and ten times compensation, depending on the years remaining until the key person's normal retirement date.
Cost to replace contributions of the key person	A key person contributes to the company's earnings each year. This valuation focuses on the replacement cost to recover the portion of lost earnings that would arise upon the key person's death.
Cost to replace lost sales profits	This method examines the potential loss of key person contributions to profits and estimates the profits that might be generated by a replacement over a period of time. The present value in today's dollars of the difference in profits determines the value of the key person. The estimated number of years the replacement will take to recover the lost profits would be selected.
Cost to replace experience	A key person may perform special duties in addition to their routine. With these special duties, the key employee brings valuable experience the company would need to replace at their untimely death. The key person's annual salary in excess of the salary for routine duties represents compensation paid for that experience. The cost to replace this value presents a loss to the company.
Loss of excess earnings	Excess earnings are the earnings of the business over and above what the owner's equity would earn in an ordinary investment. The key person's compensation is divided by the total compensation of all key persons. The resulting percentage is applied to the excess earnings (pretax earnings minus the earnings attributable to management), and the outcome is offset by the contributions made by the key person replacement.
Loss of value to the business	The key person contributes to the success of the business. With this method, a percentage of the business value tied to the key person is assigned. If that person were to leave the business, the business anticipates a decline in value by that percentage or amount.

EOLI rules

Note that Internal Revenue Code 101(j) provides special employer-owned life insurance (EOLI) rules in order for an employer to receive an income tax-free death benefit.[3] Those rules include a requirement that the employer provide notice and obtain consent from the insured PRIOR to issue of the insurance policy. In addition, there are annual reporting and recordkeeping requirements.

See Equitable's **Important Information Regarding Employer-Owned Life Insurance** (Cat. #137310) and related support materials.

1 Note that Equitable's Guaranteed Issue program for permanent, single life products has separate and specific face amount limits and participation requirements. Check with underwriting for details.

2 The amount of creditor insurance is included in the total amount of coverage available on the life of a key person. Consult the Life Underwriting Condensed Guide for Business Debt Repayment Financial Underwriting Requirements.

3 The law was enacted as part of the Pension Protection Act of 2006 and is effective for policies issued after August 17, 2006.

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