Business Insurance – Business continuation insurance

Key person insurance protects a business by providing a lump sum if a ‘trigger’ event such as death or disability results in the loss of a person who makes a significant contribution towards the profitability or stability of the business.

How it works

Businesses are not generally made successful by tangible assets, such as land, buildings, plant, equipment, stock or working capital. Rather, success depends upon the expertise of the people who put these things to work.

Key people are the most valuable asset a business can have. Their departure (especially if unexpected, e.g. due to death, disablement, critical illness or injury) could cause havoc not only to that person’s family, but also to the business and to the lives of all who remain involved in the business.

Key person contingency strategies are designed to provide the business with money to offset the financial loss resulting from the disability or death of a key person.

This money may also be used in conjunction with a business succession plan to ensure that the business remains healthy after a proprietor/key person is unable to remain in the business. This may help to ensure the remaining business owners continue to have a viable business, but does not replace insurance needed to fund a Business Succession Agreement.

Who is a key person?

A key person is someone who:

- Gets things done. They might be a manager, director, company secretary/chief financial officer, accountant, supervisor, foreman or technical specialist.
- Builds goodwill. Their human attributes and qualities inspire confidence, attract custom and build clientele. Goodwill enhances the value of the business and is vital to its continued success.
- Improves the credit standing of the business. The confidence and goodwill built up by their skill and efficiency often enhances the credit extended to a business by suppliers and bankers alike.
- Contributes to revenue either directly via sales and client account management or indirectly via technical skills which would be difficult to replace if they involuntarily departed.

What is the business impact?

The loss of a key person can affect the business. For example:

- Revenue may fall, expenses increase and profits be impacted upon. This may result in immediate loss of revenue as existing contracts may not be able to be satisfied nor new contracts sought until a replacement is found.
- It may take time and money to find a replacement and perhaps months for the new person to become fully effective. In the meantime, momentum flags and profitability may fall. This may become an opportune time for competitors to grasp an advantage.

- Others in the business may have their attention diverted, causing a decrease in productivity and downward pressure on cash flow.
- Liquidity and credit can be affected. Creditors can be quick to press for payment, debtors slow to pay and lenders reluctant to advance to a business after the loss of a key person.
- Goodwill and credit are closely linked; one tends to follow the other. Cash is often urgently needed for the financial stability of the business.
- The proprietors may feel bound to continue to pay the key person given that they are either a proprietor or at least a valued employee.
- Amounts the business owes a key person or their estate can often be called on with little or no notice.

To help protect the business in the short term, key personnel should be insured to provide sufficient funding to cover the loss in revenue. This will provide the business with some breathing space to restructure for the future, without the financial strain resulting from a reduction in turnover, following the key person's absence due to death, disablement or a critical illness or injury.

In addition, or alternatively, the business may wish to reduce the levels of debt or protect goodwill by providing sufficient funds to cover such capital costs/losses.

Insurance Policy Ownership

The business usually owns and pays the premiums for insurance policies for business continuation insurance policies.

If the cover is obtained for revenue purposes, the premium is tax deductible. Claim proceeds are paid to the business and are generally assessable as income to the business. The expenses it is used to cover may be tax deductible.

Where cover is obtained for capital purposes, the premiums are generally not tax deductible. Death benefits paid to the business are not assessable but proceeds paid for critical illness or total and permanent disablement are usually assessable to the business as a capital gain. The insured amount can be grossed-up to cover this expected tax liability.

Benefits

The insurance proceeds help protect the ongoing viability of the business and help to maintain its value by providing a lump sum that can be used to:

- offset a reduction in revenue while the business restructures or a replacement is found
- cover the costs associated with finding and training a suitable replacement
- reduce or repay debts
- protect a personal or business asset used as loan security.

Risks, consequences and other important things to consider

These include:

- The taxation treatment of the premiums and proceeds depend on the purpose and insurance policy ownership, so it is important that details about the purpose of the policies are documented in the business minutes and reviewed and recorded each year.
- The ownership of the policies should be discussed with and confirmed by your lawyer and/or accountant before implementation.

- Before selecting an insurance policy, you should always carefully read the Product Disclosure Statement (PDS) and policy document, and once you have selected an insurance policy you should keep these documents in a safe place.

Version: 6.0
Issue date: 1 July 2023