



Rx FOR SUCCESS

LATEST UPDATE:
UNDERWRITING
INFORMATION

Financial Underwriting – Key Employee

“Key Employee” insurance insures a company against the “loss” of an employee whose services are critical to the success of the organization and the expense of replacement.

A “Key Employee” is:

- ▶ an individual whose specific talents, experience, background and/or knowledge provide services that make a substantial contribution to the success of the business
- ▶ one who has a direct effect on the profits of the company
- ▶ the “one” vital factor in the success of a venture and or the security of a loan

The amount of coverage required will vary depending on the role of the key employee. With the help of a field representative, the owner/employer can use techniques to evaluate the potential loss and effects of a key employee’s death. Typically the amount of coverage requested reflects the loss of income for the business for some period of time, a percentage of an existing debt, or costs associated with finding and training an individual(s) to replace specific areas of expertise.

Underwriting a “Key Employee” is difficult when documentation supporting the need and purpose for insurance are not provided with the application for insurance. An underwriter’s evaluation begins with understanding how the amount of coverage was determined (does it make sense) and why this individual is key. Additional considerations are:

- ▶ total compensation
- ▶ if and how other key employees are covered
- ▶ beneficiary
- ▶ owner
- ▶ premium payer
- ▶ financial health of the company
- ▶ ownership interests and
- ▶ special talents/skills/history of this key employee. For example, the client is the founder of a successful company and his or her talents/skills are directly responsible for a significant part of the bottom line results.

When submitting an application for life insurance, the field representative should submit a cover letter that provides the underwriter with the business/client’s objectives and how it was determined. “Underwriting Cover Letter” (See Cover Letter Rx111) will help avoid confusion, resistance, additional requirements and or unnecessary delays.

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A Good “Key Employee” cover letter includes:

- ▶ The cost factor to replace the employee and how it was determined
- ▶ How much it would cost the business if the employee died today; to:
 - replace this individual (consider such things as recruiting and training costs)
 - cover loans and assure creditors that the business will continue operations
 - keep a positive cash flow and the business running
- ▶ assure customers that the business will continue to operate
- ▶ Total salary package (includes base salary, fringe benefits - qualified/non-qualified, stock options, bonuses, vehicles etc.)
- ▶ A biography that provides details regarding specific talents, experiences, accomplishments, education, background and knowledge that are key assets of this individual
- ▶ Information on successors, other key employees and executives, and their business insurance programs

Typically some multiple of annual compensation and/or a percentage of the debt provide a starting point for the underwriter in determining the reasonableness of the amount of key employee insurance requested. Submitting the facts with the application will help us meet your client’s needs and avoid unwanted delays.

NOTES:

- ▶ In August 2006, new tax legislation was passed impacting "employer-owned life insurance", including coverage for key-employees.

Under the new law, employer-owned life insurance death benefits are generally taxable as ordinary income to the policy owner to the extent that they exceed the total of premiums and other amounts paid by the policy owner for the policy. There are certain exceptions to this general rule.

The primary exception to this general rule concerns those death benefits where, prior to policy issuance, the **employer** provided proper notice to the proposed insured/employee and obtained the employee’s consent to the life insurance, and meets one of the following:

- The insured was an employee at any time during the 12-month period prior to his/her death, or
- The insured was a director or highly compensated employee or individual (as defined in the law) at the time the policy was issued, or
- The death benefits are paid to the insured’s heirs or designated beneficiaries (other than the employer)

The death benefit will be received income-tax free if these requirements are met and the policy death benefits would otherwise be eligible for favorable tax treatment. Failure of the employer to meet the notice and consent requirement in a timely manner will result in the death benefits being subject to ordinary income tax.

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As previously noted, the employer, not the issuing insurance company, has the obligation to satisfy the notice and consent requirement of the new law. However a sample "Notice and Acknowledgement of Consent to Insurance" document (IFS-A122705), is available. You may provide the document to your clients to assist their legal advisors in drafting the notice and consent required by the legislation. The notice is not a new business submission requirement; therefore, it should not be submitted with the application/worksheet.

If you have any questions concerning the legislation and its impact on employer-owned insurance, feel free to contact the Advanced Marketing Team.

- ▶ New York has established regulatory standards for the issuance of key person company owned life insurance to ensure the individuals being insured are in fact key persons and that the corporation would thus have an insurable interest in their lives.

According to New York regulations, for the purposes of establishing whether there exists an insurable interest at the time a policy is issued, a person shall automatically be considered a key person if:

- a.) An employee is one of the five highest paid officers of the employer.
- b.) An employee is five-percent owner of the employer. A "five-percent owner" shall mean:
 1. If the employer is a corporation, any person who owns or controls more than 5% of the outstanding stock of the corporation or stock possessing more than 5% of the total combined voting power or all stock of the corporation; or
 2. If the employer is not a corporation, any person who owns more than 5% of the capital or profits interest in the employer;
- c.) An employee had compensation from the employer in excess of \$90,000 in the preceding year;
- d.) An employee is among the highest paid 35% of all employees; or
- e.) An employee or other person who makes a significant economic contribution to the company, including but not limited to, an employee who is responsible for management decisions, has a significant impact on sales or a special rapport with customers and creditors, possesses special skills, or would be difficult to replace. Criteria for the employer's determination shall be included in the insurer's underwriting guidelines.

For the purposes of satisfying (e) above, Prudential will generally consider a person as a key person if they:

- ▶ Hold a position as Manager, Director, Officer or other such management position directing other individuals,
- ▶ Possess special skills or talents derived by education or experience and as such would require meaningful time and expense to replace,
- ▶ Are critical to sales and revenue generating activities and have a proven track record in that regard,
- ▶ Have connections or relationships with key customers or accounts that would suffer without the individual's continued involvement.

To get an idea of how a client applying for Key Employee coverage would be viewed in the underwriting process – OR – to provide the underwriter with the essential facts when submitting an application, complete the attached Ask "Rx" pert underwriter.

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Financial Underwriting – Key Employee - Ask "Rx" pert underwriter (ask our experts)

Producer _____ Phone _____ Fax _____

Client _____ Age/DOB _____ Sex _____

1. Company Name: _____

2. Nature of business: _____

3. Organization Type: Sole Proprietorship Partnership Corporation Other

4. Financial information:

Annual Sales: _____ Fair Market Value: _____

Net Profit: _____ Business Net Worth: _____

5. Are the firm and its officers free from business failures, bankruptcies or pending suits?

Yes _____

No, please give details including dates _____

6. Is Key Employee an owner? _____ If yes please provide percentage of ownership. _____%

7. Key Employee Facts including title, job duties, impact on net profits, biography, and description of why he or she is "Key" to the success of the business, etc:

8. Key Employee's total salary package including salary, bonuses, stock options, fringe benefits, etc:

9. Estimated cost to replace Key Employee: _____

10. Are other Key Employees similarly insured? _____

After reading the Rx for Success on Financial Underwriting – Key Employee, please feel free to use this Ask "Rx" pert underwriter for an informal financial review or as a source for providing financial information when submitting applications.

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