Guide to Business Protection Insurance

Overview

Why a Business Needs Protecting

The death or critical illness of a key employee or a co-owner can have a major impact on the business. It could lead to:

- A fall in sales;
- A delay to product launches;
- Delays in the completion of existing contracts (and possible financial penalties);
- A lack of confidence in the business from a bank, suppliers, customers and other employees;
- Loans may be called in;
- Suppliers may demand payment upfront;
- Customers may choose to go elsewhere; or
- An increase in recruitment costs, 'head hunting' fees, or training costs for a replacement.
- Without the cash to buy out a co-owner, the business could even end up in someone else's hands.

What is business protection?

Business protection is a type of insurance that helps protect the business against possible financial losses when illness or death affects a principal or their employees. By including business protection in the firm's business plans, it can help the business to survive and continue trading under seriously challenging circumstances.

Business protection is different to personal protection because it reflects specific business needs, for example, the insurance could cover the life of a key employee to protect against significant loss of earnings should they die or whilst they recover from a serious illness. Business protection can also be used to ensure the ability of business owners to repay a loan in similar circumstances

Who can take out business protection?

There are protection solutions available for the specific needs of different types of business, be it a limited company, sole trader, partnership, or limited liability partnership (LLP).

There are different ways of approaching business protection, particularly for partnerships and shareholders. Depending on the circumstances, it is possible to take out a ‘Life of Another’ plan or an ‘Own Life’ plan, which is then written into a business trust.

There are four main solutions:

Key persons protection

Businesses will, in most cases, own various forms of insurance either because it is a legal requirement, or to manage the risk of a financial loss to the business. However, neither of the above covers the risk of losing a key employee.

Key person protection can help insure against the financial losses that may arise if a key employee (also referred to as a key person) dies, becomes terminally ill or suffers a critical illness. It will pay out a lump sum, giving the business the funds it will need to meet its ongoing financial needs.

Who are the key persons in a business?

A key person is any individual in a business whose skill, knowledge, experience or leadership contributes significantly to its continued financial success. Key persons might include owners, directors, sales managers, research and development staff, creative or technical experts and sole traders.

Setting up key person protection

Key person protection provides insurance through a life insurance or a life and critical illness policy that can be taken out on the lives of its key people. The plan can be owned by the business, or by an individual business owner.

A claim can be made if a key person dies, is diagnosed with a terminal illness or suffers a critical illness. The proceeds can then be used to meet the financial needs of the business while it recruits a replacement or undergoes reorganisation.

Business loan protection

Many businesses take out loans to start up a company or to expand their operation. Their ability to repay that loan will often rest with a few key people. Businesses need to make sure that they have sufficient insurance in place to pay an outstanding loan if something happens to those people.

If the business has outstanding borrowings such as a loan, commercial mortgage or a director's loan, business loan protection can help repay these should one of the business owners die or suffer a critical illness. Business loan protection is similar to personal life insurance taken out to cover a mortgage. In most cases, the full amount can be protected with life cover, or life and critical illness cover. When a business makes a claim, the sum insured is paid to either the business or directly to the lender if the cover has been assigned to them.

Which types of loans can be covered?

Most types of business loan can be protected, including commercial loans and mortgages; venture capital loans; directors' loans and personal guarantees.

Setting up business loan protection

Under the terms of a business loan, owners may be jointly liable, severally liable or jointly and severally liable for the repayment of the loan. It is important to understand each individuals liability before arranging cover for each owner.

A life or life and critical illness policy can be set up for each person who has guaranteed, or is responsible for, repayment of the loan. These policies can be owned by the business, or by an individual business owner.

You can select a decreasing or fixed value sum assured, but the term of the cover must match the term of the loan.

When a claim is made, the proceeds are paid to the policy owner, who can then decide to pay off the loan in full or to continue repayments according to the initial agreement with the lender. They can also assign the policy to the lender, in which case the Insurer will pay the claim proceeds directly to the lender.

Share purchase protection

Share purchase protection is a life or life and critical illness policy. This policy allows the remaining business owners to buy the insured partner's or the shareholder's interest in the firm should one of the business owners die or become terminally or critically ill.

Setting up share purchase protection

Each shareholder can take out an 'own life' policy with a sum assured equivalent to the value of their shares. They can then write the policy into trust for the benefit of their co-shareholders.

Shareholders should agree that if one of them dies, the remaining shareholders can buy their shares from their personal representatives. Likewise, they agree that if one of them suffers a critical illness the affected shareholder can choose to sell their share, which the remaining shareholders will then be obliged to buy. These are called double and single option agreements.

Any policies you set up must also be aligned with the Articles of Association and the shareholder's agreement.

There may also need to be a trust and / or buyback document in place for them to be effective.

Partnership protection

If a business partner dies or wants to leave the partnership when they are diagnosed with a critical illness, most partners will want to buy the affected partner's share in the business and keep control but might not have enough cash to do so.

Partnership protection is taken out to ensure that funds are available to allow the remaining partner(s) in a business to buy a partner's shareholding if they die, become terminally ill or suffer a critical illness. This in turn gives each partner the security of knowing that their beneficiaries or personal representatives will have a ready and willing buyer instead of having to maintain an interest in the business.

What is a partnership?

Partnerships come in different shapes and sizes but the Partnership Act 1890 defines a partnership as "the relationship which exists between persons carrying on a business in common with a view of profit". The Act also provides a basic framework for people trading in partnership. For example, Section 33 of the Act states the partnership will be dissolved on the death of a partner.

Setting up partnership protection

Each partner takes out a life or life and critical illness policy and writes it into trust for the benefit of the other partner(s). Or, if there are just two partners, then they can each set up a personal life of another policy.

The individual partners pay the premiums. Since premiums reflect the age and sums assured of each individual partner, the amount each individual pays does not necessarily reflect the benefits they would receive in the event of a claim. However, you can adjust the premiums to reflect each partner's share in the business.

In the case of Limited Liability Partnerships (which are recognised as legal entities), the business can own the policy on the lives of its partners. All partners will need to enter into an agreement that if any one of them dies, the remaining partners can buy their interest from their personal representatives. Likewise, they agree that if one of them suffers a critical illness, the affected partner can choose to sell their interest, which the remaining partners will then be obliged to buy. These are called double and single option agreements.