# Preserving the Value of Your Business From the Loss of a Key Employee

*Business valuation is more art than science. Clearly, however, the value of the business is impacted by the presence or absence of key employees, such as experienced managers, executives or top sales professionals. There is nothing attractive about a business losing value, including sales, relationships and experience, upon the loss or departure of a key employee. If the loss occurs at a time when you are counting on getting a high business valuation (e.g., selling to a third party, applying for a business loan, cashing in stock options, etc.) the results can be downright ugly. Whether your key employee is lost to the competition, or to an untimely death or disability, the impact on your business' bottom line can be significant. The following strategies can help you protect and maximize the value of your business against the loss of a key employee.*

## (1) Executive Bonus Plans: Keeping the Competition Down and Your Business' Value Up

The value of your business is a reflection of your efficient use of business assets, including your key employees. These bright, motivated employees have helped contribute to the success of your business. Losing them to the competition may not only be a personal loss, but often translates into losses on your financial statements and ultimately a decrease in the value of your business.

Considering that one of the most common factors considered when valuing a closely held business includes assessing management depth and expertise, it is to your advantage to retain these key persons so that they continue to apply their superior skills and knowledge now and in the future, to grow your business and maximize its value.

### Executive Bonus Plans For a "Highly Valued" Management Team

Retaining key people while you are running your business can be achieved through competitive compensation packages, including an Executive Bonus (Section 162) Plan. An Executive Bonus Plan is low cost and easy to implement. Essentially, the business subsidizes the cost of a whole life insurance policy for the key employee through the form of bonus payments (disability income insurance can also be used).

The key employee owns the life insurance policy and names his or her own beneficiary/ies. The business bonuses the employee the money required for the premium payments. These amounts are taxed as ordinary income to the employee and are deductible to the business as a business expense so long as the bonus is reasonable. Ask your Guardian Financial Representative for our brochures and other informational memos on *Executive Bonus Plans* to learn more about this arrangement and its variations.

## (2) Key Person Insurance: Insuring Against the Untimely Death of a Key Employee

The day former Chairman and CEO of McDonald's, Jim Cantalupo (60), died suddenly of a heart attack, McDonald's stock lost nearly 4% of its value - even though the stock price was in the midst of an upswing. How will your business respond to the death of a key employee?

The loss of a key employee will likely be a traumatic time for you and your business. The financial impact of such a loss may be fast and furious – like McDonald's – or may result in a gradual decline in profitability. Whichever way it happens, your business' value will likely take a hit.

# Business Planning

## Key Person Insurance – Don't Let Key Person Discounts Reduce Your Business' Value

A business being valued in the aftermath of a key person's death will likely be subject to a "key person discount." The appraiser will determine how much of the value of your business should be *reduced* due to the loss of a key person.

One factor that can counter, or effectively eliminate, the key person discount is the availability of life insurance proceeds. In fact, the key person discount may be effectively nullified if the loss of the key person is "adequately" covered by life insurance.* That's because the business has the money to hire and train replacement personnel in a timely fashion. A key person permanent life insurance policy also provides your business with immediate access to cash values for emergencies during the life of the key employee.

To implement key person insurance the business must notify the key employee in writing that it intends to insure his/her life. The employee must provide written consent. The business then purchases, and is the beneficiary of, a whole life insurance policy insuring the key person. The cash value of the insurance policy is included as an *asset* on your business' balance sheet. The business pays the premiums and should receive the death benefit tax free. Ask your Guardian Financial Representative for our brochures and other informational memos on *Key Employee Insurance*.

## (3) Qualified Sick Pay Plans: Maintaining a Healthy Business Value

When Apple co-founder Steve Jobs announced his resignation in August 2011 due to his battle with cancer, Apple's stock dropped 7% that same day. Prior to his resignation, the mere mention of Jobs' health status influenced Apple's stock price, positively or negatively. Although the world may not be watching your key employees like it did with Steve Jobs, the sickness or injury of a key employee – even temporarily – can have a negative impact on *your* business' value.

A key employee's disability may translate into lower sales, increased time and costs of production, and may otherwise disrupt normal business operations. On top of these complications, the issue that inevitably arises is: Are you going to continue to pay *this* employee's wages during his/her disability? If so, are you going to pay the full amount? If not, how much? And, for how long? Wages paid to your disabled employee will place an additional strain on cash flow and - adding insult to injury (literally) – these payments may not be deductible to your business!

A business valuation performed after the disability of a key employee will likely reflect this strain – especially a business valuation that utilizes the discounted cash flow method. Any valuation method that takes into account a business' future cash flows (i.e. capitalization of income), will likely reflect lower operational cash flows, lower sales income, and/or higher expenses, thus resulting in a lower projection of future cash flows and an overall lower business valuation

## A Qualified Sick Pay Plan Funded with Disability Insurance Can Maximize Your Business' Value

A **Qualified Sick Pay Plan** (QSPP) funded with disability income insurance shifts the burden of paying a disabled employee's wages from your business to the insurance company. This will allow you to utilize these monies - that would have otherwise been paid out - when they are needed most, and will ultimately help preserve your business' value by stabilizing cash flows and expenses. A QSPP will also allow payments made to the employee to be tax deductible to the business.

# Business Planning

Simply put, a QSPP is an agreement that enables a business to shift the liability for an employee's wages during a period of disability to an insurance company, which will continue paying a portion (typically 60% – 80%) of an employee's wages. As the business' owner you are in total control of which employees may participate and the level of coverage your employees will receive. As a result, this is also an executive perk for your best employees.

Funding the QSPP with disability income insurance not only reduces a liability (wages payable) on your balance sheet – and keeps those monies within your business – but the contributions your business makes towards the QSPP are tax *deductible*. In addition, your business will not be responsible for making *any* premium payments during an employee's disability if you add a waiver of premium benefit rider to your plan.

## Conclusion

As a business owner you are committed to getting the highest value for your business. The three strategies described above **(Executive Bonus Plans, Key Person Insurance, and Qualified Sick Pay Plans)** demonstrate your commitment to your top employees and to your business, maximizes your business' value, and ensures that all of your hard work pays off.

*See IRS Revenue Ruling 59-60, § 4.02.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

Lanny D. Levin, CLU, ChFC
**LANNY D. LEVIN AGENCY, Inc.**
1751 Lake Cook Road suite 350
Deerfield, IL 60015
(847) 597-2444
lanny_levin@levinagency.com



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