Key Man Life Insurance & Purchasing a Member's Interest

Article By:

McBrayer, McGinnis, Leslie & Kirkland, PLLC

Sometimes entrepreneurs get so caught up in the day-to-day operations of their business that they forget to look ahead to the "ifs" that the future may hold. One important "if" that everyone business owner should consider is, "What would happen to the business if one of the owners or a key employee should suddenly die?" Failure to properly plan for the death of an owner or key employee can lead to unintended consequences for the business. For example, the Company could be faced with liquidity issues if it is forced to buy out the interest of a deceased shareholder with a lump-sum payment. Another unintended consequence is the possibility that the deceased owner's spouse could become your business partner if there are no restrictions on the transfer of ownership interests in place.

Obtaining a key-man life insurance policy along with implementing a buy-sell agreement (discussed below) will go a long way in avoiding these potential pitfalls. Key-man life insurance is a company-owned life insurance policy on the life of an owner or key employees of the business. Under such a policy, the business pays the premiums of the policy and is the beneficiary of the policy. Upon the death of the insured, the company, as the beneficiary of the policy, receives the proceeds of the policy, and such proceeds are generally tax-free to the company. The company, in turn, will use the proceeds from the key-man policy to purchase the deceased owner's interest in the business.

Without some mechanism in place to account for the handling of an owner's interest at his/her passing, the deceased's interest in the company will pass to the beneficiaries of the deceased's estate. This could potentially result in you becoming 50-50 partners with a spouse who has no expertise in running the business and would rather just collect a check than help you deal with personnel matters. A buy-sell agreement, coupled with a key-man life insurance policy, will help ensure a seamless transition upon the passing of an owner of the business. A typical buy-sell agreement stipulates that upon the death of an owner, the company will purchase the deceased owner's interest in the company from the deceased's estate at a pre-determined price. When the buy-sell agreement is funded by a key-man life insurance policy, the liquidity issues associated with making a lump-sum payment to purchase a deceased owner's interest in the company are no longer a concern for the company.

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