

# *Business Disability Insurance*\*

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The disability of a business owner or professional presents unique and complex problems. Fortunately, there are a variety of special disability products available to cover specific business-related losses due to the disability of the business owner or key individuals.

For the sole proprietor or professional, disability threatens not only his or her earned income but also the continued existence of the business. The owners of a closely held business may also be placed in a difficult situation if one or more of them should become disabled. The typical closely held business owner or professional receives all (or a substantial portion) of his or her income from the closely held business or professional practice. Furthermore, the ownership

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\* Reprinted from *Disability Income Insurance: The Unique Risk*, 5th edition (The American College, 2002) by Charles E. Soule. Portions of this chapter are based on material written by Ted Kurlowicz, James F. Ivers III, and John J. McFadden for *Planning for Business Owners and Professionals*, 7th edition.

interest in the closely held business is likely to be the owner's most substantial asset.

There are four principal risks that the business owner or professional must protect against the possibility of disability:

- *income protection of the owners and principals.* This is basic disability income insurance to replace the owner's income when disabled, but the income protection need becomes complicated in business situations. The owners of a closely held business usually have a close relationship and will probably want to continue a co-owner's salary during a period of disability. However, a conflict is almost sure to occur if the business does not have provisions for continuation of an owner/employee's salary during disability. The income-protection process is smoother and more certain when the owners have a prearranged binding agreement funded by disability insurance, commonly called a salary continuation plan.
- *business overhead expense coverage.* The purpose of this coverage is to provide reimbursement for certain specified business expenses to allow the business or practice to remain viable during the disabled owner or principal's recovery and return to work. This need can best be answered by a disability contract specifically designed to cover business overhead expenses.
- *buy-sell funding.* While business overhead expense disability coverage is designed to provide reimbursement for business expenses during relatively short disabilities, a business owner's permanent or long-term disability requires a different solution. A specially designed buy-sell disability contract will help fund the buyout of the disabled owner's share of the business.
- *key person protection.* Finally, in some instances the closely held business may be especially dependent upon the special skills of a key employee. The disability of this key person may substantially impair the business's finances, especially for the short term. Again, there are specially designed disability products to fund this need.

These four business disability needs will be discussed throughout this chapter. It is important to understand, however, that the basic disability income product is specifically designed to replace the insured's lost income and is *not* designed to meet the business needs of overhead expenses or buy-sell or key person disability. These three needs do not involve protecting the disabled owner's income, but rather are situations that address the financial problems the business experiences when an individual is disabled. Consequently, specifically designed contracts to meet these unique business needs are the best and most efficient means to satisfy the risks. Attempting to solve these business needs with the basic disability income contract usually creates unnecessary complexity and problems. For example, the specially designed business overhead, buy-sell, and key person contracts each have elimination periods, benefit periods, and contract

language to meet these specific needs. In addition, underwriting rules and limits specifically recognize the unique needs in each situation. The basic disability income contract is not designed to match and dovetail with the specific business needs of overhead expense, buy-sell, and key person coverages.

The problems associated with the premature death of a business owner or professional are generally recognized and contingency plans are made. The disability risk, however, is often ignored. Individuals and employers insure against the risk of death more frequently than against the risk of disability. In fact, some industry studies indicate that 81 percent of United States households have at least one member who owns life insurance. Of course, life insurance can be purchased by virtually any individual, while disability income protection is usually available only to individuals with earned income. Some states require limited indemnity disability benefits be made available to homemakers. But even when we focus solely on employed individuals, the percentage of people with disability protection is surprisingly low. The total number of individuals covered by some form of long-term disability income coverage excluding Social Security, was less than 40 million people in 1999.<sup>1</sup>

Financial services professionals should be aware that most people do not have formal disability income protection and should advise their business and professional clients of the possible options available.

Because the disability risk is less frequently considered than the life insurance risk, it would be at least comforting to know that disability risk is less significant. Unfortunately, this is not the case. First, a working individual is far more likely to sustain a disability of significant duration than to die prematurely. Second, the problems created for the disabled person and his or her family are often greater than those created by an individual's death. Finally, the continuation problems a business faces following an owner's disability are more difficult to handle and require more complex planning than the continuation planning for an owner's death.

Fortunately, most disabilities are short term in nature and are not a significant financial burden to the business. Generally speaking, therefore, both the disabled worker and the employing business may be able to manage the short-term loss. Most disability insurance contracts today do not provide for coverage for disabilities that are less than 30 days, and many contracts do not provide coverage for disabilities that last less than 90 days. Table 6-1 shows there is a greater likelihood of a business owner's significant disability than of death during the working years. The statistics reveal that the likelihood of a disability of at least 3 months far exceeds the chance of death at all relevant ages. The disparity between the frequency of these risks has increased in recent years and will continue to increase with improvements in life expectancy. As a matter of fact, as life expectancy improves, there is a tendency for more people to remain totally disabled for a longer period of time.

The frequency of long-term disability is a problem that the closely held business owner cannot afford to ignore. Historical statistics reveal that a firm

<b>Likelihood of Death Before Age 65 Compared with Likelihood of Disability of 3 Months or Longer Before Age 65 at Selected Ages</b>		
Age	Likelihood at Death *	Likelihood of Disability of 3 Months or Longer **
25	20%	58%
30	19%	54%
35	18%	50%
40	18%	45%
45	17%	40%
50	15%	33%
55	13%	23%

\* U.S. Department of Health and Human Services, Vital Statistics of the United States, 1992  
\*\* 1985 Commissioners' Disability Table A

established by two 35-year-old co-owners faces a 75 percent probability that at least one owner will sustain a long-term disability prior to age 65.<sup>2</sup> If the firm was formed by six or more co-owners, it is almost a certainty that there will be at least one long-term disability before the owners reach age 65. Since many disabilities lasting at least 3 months may continue for more than 5 years, even one such occurrence could have a devastating effect on a closely held business.

## **DISABILITY INCOME PROTECTION**

Basic disability income protection is the first disability need that a closely held business must address. Indeed, a few insurers will not consider providing business overhead expense or buy-sell coverage until the basic income protection need is satisfied with either group or individual disability insurance.

The business may be able to take care of the short-term business disability from its own resources up to 30 days, 60 days, or perhaps longer. Each business or profession must address its own special circumstances in determining how long it is able to fund short-term disabilities. However, every business will reach a point at which it must address the possibility of a long-term or a permanent disability to the owner-employee.

Under most circumstances the closely held business will not be able to meet salary payments to the nonproductive disabled owner indefinitely. The healthy owners face the strain of continuing their own services to the firm, along with picking up all the responsibilities of the disabled owner. If the salary continuation payments are terminated by the healthy co-owners, the disabled owner and his or her family will have to rely on other sources of income to maintain their standard of living. The individual disability income contract is an efficient means to provide this funding.

## Salary Continuation Plans

Most closely held corporations should consider a formal corporate *salary continuation plan*. A qualified salary continuation plan provides tax benefits both to the corporation and to the plan participants. The plan can be funded in advance through purchase of insurance by the corporation or by contributions to a savings fund. The tax benefits of a properly designed plan are as follows:

- *deductibility of contributions by the corporation.* Salary continuation plans provided by corporations can be either insured or uninsured. Insured plans typically provide that the corporation pays the premiums for the insurance, while the employee is the recipient of the proceeds. Under this type of plan, the premiums are a deductible business expense to the corporation. The deduction is limited by the reasonable-compensation test, taking the participant's premium costs and other compensation into consideration. An alternative design for insured salary continuation plans is for the corporation to be the owner and beneficiary of the insurance policy. The disabled participant is paid by the corporation and not directly by the insurer. Under this arrangement, the premiums are nondeductible by the corporation.
- *contributions excluded from the employee's gross income.* Employer contributions to fund a salary continuation plan, whether insurance premiums or deposits to a savings fund, are excluded from the participant's gross income. Thus a properly designed plan will not create taxable income to a participant when the advanced funding occurs.
- *receipt of proceeds and the payment of benefits by the corporation.* If the corporation is the owner and beneficiary of the disability policies, the benefits are received tax free by the corporation when a participant becomes disabled. The corporation will be able to deduct reasonable salary continuation payments to the participant when the insurance benefits are used to make these payments.
- *receipt of salary continuation payments by the employee.* The plan benefits received by the disabled participant from either the insurer or the corporation are generally taxable income.

### *Establishing a Formal Salary Continuation Plan*

Tax rules define a salary continuation plan as an accident or health plan. The plan may cover one or more employees, and there may be different plans for different classes of employees. The plan may be either insured or uninsured, and it is not necessary either that the plan be in writing or that the employee's rights to benefits be enforceable. If such rights to benefits are not enforceable, benefits will be deemed to be received from a salary continuation plan only if a plan or corporate policy providing for the salary continuation payments in the event of disability actually exists when the employee becomes disabled. Knowledge or

notice of this plan or policy must be reasonably available to the participating employee. Because the plan must be for the benefit of employees, shareholder-employees of a corporation are eligible, whereas sole proprietors and partners are not, although the sole proprietor or partnership may establish a salary continuation plan for its employees.

The payment of benefits by a corporation may have an adverse effect unless a salary continuation plan has been established. The possibility that the IRS will challenge the legitimacy of these salary continuation plans is amplified by the fact that most closely held businesses provide these plans solely for shareholders and perhaps a few key employees. For this reason it is recommended that the corporation formally adopt the salary continuation plan and provide the participants with enforceable rights. These actions will both help establish the status of the plan for the IRS and offer assurance to the participating owner-employees that the benefits will be received.

### ***Avoiding Discrimination Restrictions***

Many types of employee benefit plans have nondiscrimination rules with which the employer must comply. Fortunately, these rules are not applicable to salary continuation plans if benefits will be included in the employee's gross income. For this reason the salary continuation plans discussed here may be provided on a discriminatory basis—that is, the plans can be limited to the owner-employees and key personnel. The corporation may also have separate plans for different classes of employees. Therefore the closely held or professional corporation can have a salary continuation plan for its owner-employees without making similar expenditures on behalf of regular employees.

Caution must be exercised when establishing a plan or class of employees for which the only criterion is stock ownership. Because the plan must be for “employees,” the underlying criteria for categorizing shareholder-employees must be in their capacity as employees and not as shareholders.

### ***ERISA Requirements***

Salary continuation plans are considered welfare benefit plans for the purposes of ERISA. ERISA generally requires a written plan document and substantial reporting and disclosure requirements to plan participants and the Department of Labor. A salary continuation plan limited to highly compensated employees and key management personnel is exempt from most of the reporting and disclosure requirements; however, a written plan document must be provided to the Department of Labor upon request.

### ***Checklist for Establishing a Plan***

Tax benefits may be lost if the corporation provides benefit payments to employees in the absence of a salary continuation plan. The corporation should

therefore take the following steps to provide evidence that a formal plan has been established:

- Adopt a written plan that includes provisions for the receipt of benefits by covered participants.
- Provide for benefits to be related to compensation and services performed and received upon absence from the work due to disability.
- Approve the plan at the board of directors meeting.
- Give notice of the plan to participants.

### ***Funding Considerations***

A salary continuation plan can either be funded or unfunded. Generally speaking, it would be impractical for the small, closely held corporation to self-fund a salary continuation plan in advance. A huge fund would have to be established immediately because the occurrence of disability is unpredictable and a long-term disability could create an enormous liability to the corporation.

There are many advantages to funding the formal salary continuation plan with long-term disability insurance:

- The burden of determining when disability has occurred and when payments should begin is transferred to the insurance company.
- The shareholder-employees have assurances that their salary will be continued during a period of disability even if the business fails.
- The cost of the plan is predictable to the corporation.

### ***Corporate or Individual Ownership of Disability Insurance?***

The primary purpose of salary continuation plans is to provide for the maintenance of the shareholder-employee's standard of living during a period of disability. It should not matter for this purpose whether the insurance protection covering the risk is provided by the employing corporation or by individually owned insurance. However, the differences in the tax consequences of each arrangement should be considered. The tax treatment of corporate-owned policies was previously discussed. If the shareholder-employee purchases individual disability income insurance, the premiums will be paid in after-tax dollars, but the benefit payments received upon a disabling event will be tax free. (See table 6-2 for a review of the tax treatment of various plans.)

In summary, then, the first business need to be covered is income protection. An experienced financial planner can help the closely held business decide on the specific design of the salary continuation plan.

## **BUSINESS OVERHEAD EXPENSE (BOE) INSURANCE**

The oldest and most commonly sold form of business disability insurance is the *business overhead expense (BOE)* contract. The purpose of this contract is to



provide reimbursement for certain specified expenses so that the business or practice may remain viable during the recovery and return to work of the disabled owner or principal. These benefit payments are usually for the short term and assume that the business owner will return to work.

This risk is particularly important for the professional operating a solo practice or partnership. The professional practitioner can lose clients, goodwill, valuable employees, and indeed the business as a whole if office expenses cannot be paid during a period of disability. The professional's career could be destroyed even with a short-term disability.

### **Eligibility Requirements**

The basic need for BOE insurance depends on whether or not the business entity will be able to generate the income to cover expenses during the owner's absence because of disability. Underwriting requirements help identify the professional or business owner whose disability would create a significant loss of revenue and thus a loss of monies to pay expenses. The law firm with five or fewer principals, for example, would clearly have a change in revenue if one of those principals was disabled for even 2 or 3 months. The owner of a small business who is also key to the success of the business would similarly have difficulty paying certain fixed expenses if disabled, especially if he or she does not have other employees to carry on the same work with the same skills. On the other hand, a large group practice of 30 physicians in the same specialty will not usually suffer much overall loss of revenue if one of those individuals is disabled for a period of time. Criteria to determine eligibility may involve the nature of the business, occupation class, and the number of principals as well as the number of employees doing the same or similar work as the owner or directly involved with the generation of revenue.

### **Covered Expenses**

Most contracts cover fixed monthly expenses that are ordinary and necessary for the operation of the business or profession and would continue in the event of disability. These expenses may include but are not limited to rent, utilities, equipment rental, employee salaries, certain interest expenses, office supplies, and property taxes. If expenses are shared with other principals, the amount of coverage per individual is limited to the individual's share of expenses. Expenses that are not covered usually include those directly associated with the generation of income and therefore would not occur during disability. Examples of these expenses are the cost of goods sold such as medical and dental supplies, the purchase of new equipment, laboratory fees, and salaries paid to individuals who provide the same or similar services as the insured.

Certain types of businesses may present particular challenges in the area of overhead expenses if the owner's disability does not significantly affect the income of the business, especially on a short-term basis. Even though the

owner/manager is important to the BOE coverage of the business, employees of the firm may continue to generate some income while he or she is disabled. In these situations, the amount of BOE coverage should be reduced in proportion to the risk being considered. As stated earlier, the larger the business, the fewer the technical skills, and the greater the number of employees, the less the need for BOE coverage.

## **Benefits**

As has been stated, the purpose of the BOE contract is to provide benefits until the disabled principal or owner recovers or, in the event of a longer-term disability, until a decision can be made regarding the future of the business with a permanently disabled principal or owner. Elimination periods are generally short (30 to 90 days), benefit periods range from 12 to 24 months, and indemnity amounts range anywhere from \$2,000 to \$20,000 per month, depending on the particular circumstances. Some BOE products offer a residual or partial benefit, and some also offer a limited survivor benefit in the event of death. In addition, some contracts provide for increasing the limits under the contract periodically to adjust for normal growth in expenses that require more coverage.

## **Contract Provisions**

Certain contract provisions are commonly found in and are unique to the business overhead expense contract. Because benefits are based on reimbursement of actual expenses incurred, there are situations in which it is possible that the maximum monthly benefit or the total benefit may not be paid. Some unused benefits may be carried over to a later month, or the benefit period may be extended if the maximum benefit amount has not been used. If other similar coverages are in force with another company, benefits may be reduced according to a formula to avoid duplicate payment. Another unique benefit is the supplementary coverage (usually optional) that will cover wages or the salary expense to hire a replacement to perform the insured's duties. Finally, some companies provide a limited conversion benefit when the insured is no longer eligible for BOE benefits but can qualify financially for additional basic disability coverage.

## **Taxation**

Taxation of the business overhead expense insurance plan differs from taxation of an individual disability income policy. The business may deduct the premiums for BOE insurance as a business expense, which is similar to property and liability coverages. Unlike individually owned disability income insurance benefits, the benefits from BOE insurance are taxable income to the business; however, they may be offset by subsequent expenses when tax returns are filed.

## **Claims**

It is important to understand that BOE policies are designed to reimburse the claimant's business for actual expenses incurred. This means that at claim time, the claim payment is based on actual expenses rather than being an automatic flat monthly indemnity. In other words, a \$5,000-per-month BOE policy may pay less than this amount if the expenses at the time of disability are less than this figure. Claim examiners normally require verification of actual expenses paid before reimbursing claimants.

The financial services professional should be alert to the need for business overhead expense protection in sole proprietorships, partnerships, limited liability companies, and closely held corporations. Although the income protection need, the buy-sell funding need, and the key person protection need have comparable products in life insurance, the BOE need is unique to disability insurance and is frequently overlooked or misunderstood by the life insurance salesperson. To a small business, the financial consequences of the owner/employee's short-term disability can be devastating.

## **DISABILITY BUYOUT INSURANCE**

The purpose of disability buyout coverage is the same as that of life buyout insurance (that is, to fund the purchase/sale of the insured's ownership interest in a business or professional practice by his or her partners, co-shareholders, or the business entity). The triggering event is the disability, as opposed to the death, of one of the principals.

When a disabled owner begins to feel the financial strain resulting from the loss of earned income from the business, an obvious solution is to sell the business interest. This solution will offer satisfactory results for all the parties involved if it is planned for in advance. Here again, however, this need for continuation of the business usually receives less attention in relation to the owner's disability than it does in relation to the owner's death. In the absence of a prearranged binding agreement, the disabled owner is likely to be dissatisfied with the sale proceeds. It may be difficult to dispose of a closely held business interest to an outsider, particularly if the disabled owner holds a minority interest in the business. Similarly, if the disabled owner has unique and special skills that affect the value of the business, it may well be difficult to find a buyer who is willing to pay an amount that is acceptable to the disabled owner.

If the disabled owner and the healthy co-owners can reach an agreement, the disabled owner's interest can be transferred to the remaining owners, preventing any unwanted outsiders from entering the business. Unfortunately, the disabled owner will be in a precarious bargaining position, because if he or she has a minority interest, the healthy owners can terminate income payments to the disabled owner at their whim. Under these circumstances, the disabled owner is likely to be compelled to accept a purchase price far below the fair value of the interest.

In some circumstances—for example, a partnership in which any general partner can force liquidation or any corporation in which the disabled shareholder holds a majority interest—the disabled owner may be in a position to force the liquidation of the business. A forced liquidation is unlikely to satisfy any of the parties. A liquidation results in business assets being disposed of quickly and generally below fair market value. The business may lose goodwill, and the healthy owners will temporarily lose their livelihoods. In any event, the disabled owner will not receive adequate proceeds for his or her interest in a forced liquidation.

## **Disability Buy-Sell Agreements**

An obvious solution to the problems created by a business owner's long-term disability is to draft a comprehensive buy-sell (purchase-and-sale) agreement between the business and its owners prior to the occurrence of any triggering events. It is at this time that all parties to the agreement are in their strongest bargaining or negotiating position. Because the continuation problems created by an owner's death are similar to those created by disability, it is natural to incorporate a provision in the life insurance buy-sell agreement to consider the contingency of an owner's disability. The financial services professional should advise business clients of the hazards of disability and make them aware of the possibilities of incorporating disability provisions into a new or existing life insurance buy-sell agreement.

The purpose of the agreement is to provide an orderly transfer of ownership in the event that any one of a number of situations arise, such as death, retirement, voluntary or involuntary termination, or disability. By stipulating the disposition of an owner's interest in the business before a triggering event occurs, the agreement allows for continued ownership and uninterrupted business. It also protects the remaining owners from undesired new owners, and it protects an owner's value in the business.

Disability buyout insurance, as with life insurance, is simply a funding vehicle to the underlying buyout agreement. It protects the parties from certain financial losses that may occur if an owner who was actively and productively involved in the business becomes disabled. The types of losses that may occur are the drain on business assets in order to support the disabled owner, the disabled owner's lack of productivity that may cause the value of the business to decline, and the reduction of future profitability for the remaining active owners.

Buy-sell agreements that become operative at the disability of a closely held business owner are structured in the same basic form as life insurance agreements. The business entity or the co-owners can be the intended purchasers. In a partnership, a cross-purchase agreement is an agreement among partners to purchase the partnership interest a disabled partner holds when the agreement becomes operative. In an entity buy-sell agreement, the partnership is a party to the agreement and is the designated purchaser of a disabled partner's interest.

Corporate disability buy-sell agreements are designed as either cross-purchase or stock-redemption plans. Again, in the cross-purchase agreement each shareholder agrees to purchase a designated portion of a disabled co-shareholder's stock when a disability triggers the agreement. Each co-shareholder entering the cross-purchase agreement is similarly bound to sell his or her stock when the specific nature of the disability meets the provisions described below. The stock-redemption disability buy-sell agreement binds the corporation to redeem a disabled shareholder's stock. Each shareholder entering the agreement must agree to have his or her stock redeemed when he or she becomes disabled, according to the terms of the agreement.

The disability buy-sell agreement can be designed in a mandatory fashion as described above, or the owners can be given an option to buy a disabled owner's stock. An optional agreement offers flexibility to the parties by delaying the actual decision to purchase the disabled owner's interest until the circumstances are known. However, the basic purpose of a disability buy-sell agreement dictates the use of a mandatory agreement. Such an agreement ensures that a disabled owner will have a guaranteed market for his or her business interest and will receive fair proceeds that can be used by the owner and his or her family during the period of disability. At the same time, the healthy owners can enjoy the assurances that a binding agreement provides—that is, they will not have to deal indefinitely with a potentially disabled and disgruntled co-owner who might sell to outsiders or force the liquidation of the business.

### **Provisions of a Disability Buy-Sell Agreement**

Typically, disability buy-sell agreement provisions will be incorporated in one agreement providing for all the contingencies the owners stipulate to trigger a buy-sell agreement—death, disability, retirement, and so on. The inclusion of disability as a triggering event creates the need for the following provisions:

- *elimination period*—The elimination period in a disability buy-sell agreement is the amount of time that must elapse following the onset of the owner's disability before the purchase must occur. The date the buyout agreement becomes operative is also referred to as the *trigger date*. The elimination period in the agreement must be consistent with the elimination period in the buy-sell policy.
- *definition of disability*—This provision specifies the degree of disability that an owner must face before a purchase becomes mandatory. Here again, the definition of disability should be the same as in the disability policy, and the determination of disability is typically left to the insurer.
- *recovery of the disabled owner*—The possibility exists that a disabled owner will recover sufficiently to provide the usual services to the business. This recovery could occur either during or after the elimination period. If recovery occurs during the elimination period, it is

commonly provided that a new elimination period will have to be satisfied if the disabled owner returns to work for a reasonable length of time. If recovery occurs after the elimination period, the buyout will already have been triggered, and it is normal for the buyout to be completed.

- *funding*—A disability buy-sell agreement offers more certainty if it is funded in advance, and specially designed disability buy-out insurance is the most efficient vehicle to use. If the agreement is to be insured, this provision will stipulate all the specifics related to the insurance funding, including the purchaser, the premium payer, and the beneficiary of each policy.
- *disposition of policies held by the seller after a buyout has become effective*—If a disability buy-sell agreement is insured, there will be one or perhaps several policies covering each owner. Each owner may also be covered by life insurance as a means to fund the death provisions of the buy-sell agreement. This provision will specify the method of disposition of any unnecessary insurance policies after a buyout occurs following either the death or the disability of an owner.
- *premature death during the period of disability buyout*—Disability buy-sell agreements are often carried out through installment obligations. In such a situation, the disabled owner may die before all the installment payments are made. It is usually recommended that the life insurance covering each owner under the life insurance buy-sell agreement be continued until the disability installment payments are completed. This provision might stipulate that the disabled owner's death will accelerate the installment obligation and the balance will be due in one lump sum. The purchasers can then use the proceeds of the life insurance policies to complete the buyout.

### ***Triggering the Buyout***

The selection of the operative event for the disability buy-sell agreement gives some discretion to the parties that is not available in the buy-sell agreement at death. That is, death is relatively easy to define and offers no chance of recovery, whereas disability occurs in varying degrees and may be either temporary or permanent in duration or either total or partial in severity. The effect of an owner's disability on a closely held business will vary depending on the owner's status and the type of business. For example, a business that does not depend on the personal services of the owners may be able to operate with a disabled owner for an indefinite period of time. A professional who provides counseling services to clients may be able to perform substantially all of his or her normal duties after sustaining a disability that causes substantial physical impairment. The drafter of the disability provisions of the buy-sell agreement must take the specific circumstances of each closely held business and its owners

into consideration when designing the provision of the agreement specifying the event that will trigger the buyout.

### ***Definition of Disability***

The definition of disability in an insured agreement should never be more liberal than the definition used in the disability buy-sell policy. Otherwise, the parties could become bound to a mandatory buyout at a time when no benefits are forthcoming from the funding insurance contract. For this reason, financial services professionals typically recommend that the insured disability buy-sell agreement contain the identical definition of total disability used in the insurance contract. This places the burden on the insurer to determine when the benefits will be paid and thus when the buyout will occur. The use of the insurer's definition removes the potential for a dispute among the parties to the agreement. Furthermore, it ensures that benefits will be forthcoming when the agreement becomes effective.

Insurers currently offer policies with varying definitions of disability to suit the needs of specific business and professional clients. The specific types of disability definitions are discussed elsewhere in this textbook. Suffice it to say that most buy-sell contracts use an *own-occupation* definition of disability, which states that "total disability shall mean the continuous inability of the insured to engage in his or her regular occupation or profession due to illness or injury."

Some disability buy-out insurance policies have a hybrid definition of disability that is specifically applicable to the closely held business buy-sell situation. Under this definition, benefits will be provided if the insured is unable to perform the duties of his or her regular occupation and any other occupation within the business organization for which the insured is reasonably suited in consideration of education, training, and experience. Under these circumstances, the buyout will be completed and the benefits will be paid when the disabled owner or professional is unable to contribute productively to his or her specific business or professional practice.

### **Buy-Sell Insurance Policy**

Unlike business overhead expense policies, buy-sell policies are not truly noncancelable or guaranteed renewable in the strict sense. The insurer often conditions renewability of the contract on

- the insured's being actively at work in the business
- the insured's owning not more than 90 percent or less than 10 percent of the business
- a written buy-sell agreement in place

Because the purpose of the policy is to fund a one-time event (that is, the disposition of the insured's interest in a specific business), the policy benefit is paid only once. As previously mentioned, it is important that the provisions of the *agreement* and the *policy* be consistent. Like business overhead expense policies, buy-sell policies reimburse the policyowner for the actual buyout expenses. Because the buy-sell policyowner is not the insured, the reimbursement requirement protects both insured and insurer from a situation in which the policy proceeds are used for something other than purchasing the insured's ownership interest. A unique provision of many buy-sell contracts is that the insured is presumed to remain disabled once the buy-sell benefit becomes payable. This provision ensures that benefits will be available to fund the purchase even if the insured recovers from the disability before all benefits are paid.

The typical elimination period under a disability policy is 24 months. Some insurers offer optional elimination periods with higher benefit amounts for longer elimination periods. The length of the elimination period must take into consideration the specific business's needs; however, with each successive month that an owner is disabled, there will be increasing pressure on the healthy owners. Consequently, a one- to 2-year time frame is typically the selected elimination period.

### ***Form of Buyout Payments***

The purchase price for a disabled owner's interest will be in the form of either a lump sum or an installment obligation. Lump-sum purchases are impractical to fund in disability buy-sell agreements unless there is a specific insurance contract providing the funding. It is simply not realistic that a business entity could accumulate enough cash in anticipation of a possible buyout.

Several insurance companies now offer special disability buyout insurance plans, and some of these contracts provide a lump-sum benefit when the elimination period has been satisfied. Other buyout policies provide for periodic payments over a 2-, 3-, or 5-year period once the buyout trigger (that is, the elimination period) has been satisfied. However, the maximum benefit available under buyout contracts is usually limited to a specific percentage of the value of the insured's ownership interest. Therefore, even if a disability buyout contract is purchased, there may be a gap between the amount of proceeds and the required lump-sum purchase price.

Insurers will issue buyout protection with benefit limits up to a specified percentage of the purchase price. The percentage participation limits may vary from 80 to 100 percent, but virtually every insurer reduces its participation after the insured business owner reaches age 59. Aggregate limitations also exist for this type of policy, which may also be somewhat restrictive. The regular policy limitations range from \$500,000 to \$2 million depending on the insurer, and they are affected by the combination of the elimination period and benefit period selected, as stated previously. Again, the coverage available will vary with the

type of occupation class for the business, the type of business, and any unique situations in the specific business. Larger policies may also be negotiated with specialty underwriters.

The amount of benefits available under these special disability buyout policies is often related to the elimination period. Higher limits are available as the elimination period increases. Elimination periods of the buyout policies are typically longer than those found in traditional income replacement policies. For example, elimination periods of 24, 36, or even 60 months are available with some policies.

As mentioned previously, some plans provide for lump-sum benefits. The traditional and most common method of payout, however, is the periodic payout. Usually, the insurer will provide higher total benefits on a periodic-payout basis than on a lump-sum basis. The longer the period of payout, the higher the benefits are likely to be.

### **Financial Underwriting the Disability Buyout Policy**

Insurers carefully underwrite the disability buyout risk. As we discussed earlier, insurers may provide protection for only a specified percentage of the actual purchase price. It is usually required that the purchase price be fixed in the agreement, including a provision for annual review. Insurers will demand financial data from the closely held business to determine that the purchase price is not excessive. The insurers apply some type of formula evaluation method to the data to arrive at the estimate of the fair market value.

Careful medical and financial underwriting are necessary in the disability buyout underwriting process to avoid situations in which an older owner may be encouraged to “retire” on the disability contract to effect the buyout.

The sales and underwriting processes for disability buyout situations are lengthy and more complex than those for the regular disability income sale. The coordination between the buyout agreement and the policy itself and the underwriting of multiple owners add to this complexity.

### **Claims**

The administration of a buy-sell claim is significantly different from other types of disability insurance claims. Besides determining if the insured meets the definition of disability, the claim examiner must also determine if an actual buyout has or will occur with the business entity named in the application. Thus the examiner must obtain not only medical documentation but also documentation of the buy-sell transaction.

The long elimination periods that are part of buy-sell policies encourage late-notice claim problems. Examiners should anticipate these problems by using the documentation of disability required under regular disability or business overhead expense policies to address a potential buy-sell claim. When it becomes clear that a buy-sell claim is probable, the examiner should obtain the

buy-sell agreement and begin to become familiar with the potential buy-sell transaction. The examiner will also request up-to-date financial information to determine the current financial condition of the business. This preparation will enable the examiner to make timely requests for stock transfer certificates, promissory notes, or other documents that might be unique to the buy-sell claim.

### **Tax Considerations**

The tax rules applicable to lifetime sale, liquidation, or redemption of an owner's business interest are applicable to the disability buy-sell situation. The tax specifics are summarized in table 6-3.

## **KEY PERSON DISABILITY**

The final disability business need is key person disability insurance. Key person disability is a late and perhaps reluctant addition to business disability insurance contract portfolios. Although the key person concept has been used in life insurance for a long period of time, disability insurance presents some special problems.

There is no quarrel with the basic assumption that, particularly in a small business, there are key employees who are critical to the business's continuing financial success. However, the unique stability and motivation characteristics of the disability contract pose certain challenges. How much does the loss of the key person affect the firm's income during that person's disability? How long does this effect last during the key person's disability? How unique is the skill of this particular employee? Are there other employees who perform the same or similar functions? How can the insurer be certain that the key employee today will also be a key employee at the time of a claim? How does the insurer avoid the employer's temptation to fund early retirement for the older employee who was once a key person? As a result of these unique variable factors, the underwriting of key person disability is very strict. This restrictive underwriting limits the sales and marketing potential of the product.

Even with these difficulties, some disability companies offer key person contracts. These contracts tend to be renewable policies that have a minimum 90-day elimination period and a benefit period that rarely exceeds 3 years. The purpose is to provide a vehicle to compensate the company for the loss of the key employee's unique skills. Key person insurance does *not* replace the lost income of the disabled employee, but reimburses the company for the loss of his or her services.

Because of the above concerns and questions, key person disability policies usually have certain renewal provisions, including a term period such as 5 years. Generally, benefits are a factor of the insured's income. They are payable for a period of months to protect the business from a potential loss of revenue directly related to the key person's effort. Claim handling is complicated by the fact that

the key person has no incentive to provide proof of claim because benefits are not paid directly to the claimant.

Key person coverage is still in its experimental phase for disability insurers. Nevertheless, further growth in this area of business insurance is anticipated as these contracts and their purpose become known and understood by producers and customers, and as insurers find way of making the underwriting less restrictive.

In summary, the business needs for disability insurance are similar to the needs for life insurance in some ways and different in others. Because the disabled employee is alive and participates in the claim process, both the underwriting and claims administration are complicated. Some insurers require that basic group or individual disability income protection be in place before considering further coverage for business needs, such as business overhead expense insurance or buy-sell insurance. It is important to understand that basic disability income protects and replaces the insured's earnings when he or she is disabled. Business overhead expense, buy-sell, and key person coverages, on the other hand, do not replace the disabled person's income, but are various means of providing funding for the economic losses to the business that occur as a result of the disability of the owner or key employee. To meet these needs in the most efficient way, financial services professionals should make sure that business owners understand that various policies are designed specifically for each need, and they should caution clients against using a basic disability income policy to meet other business needs.

## NOTES

1. LIMRA, "1999 Individual Disability Income Issues and In-Force Survey" and "U.S. Group Disability Insurance: 1999 Sales and In-Force."
2. Allan B. Checkoway, "Insuring the Disability Hazard in the Small Closely Held Corporation." *Journal of the American Society of CLU & ChFC*, January 1985, based on 1964 Commissioner's Disability Table.