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Disability Buyout Considerations

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Abstract: *Buy-sell agreements typically address measures to be followed if a business owner dies, as well as a host of possible lifetime "triggering events" that may lead to a sale of the owner's business interest. Not enough attention is typically paid to the prospect that an owner may become disabled. A proper buy-sell agreement should consider the following: (1) disability buyout versus disability income, (2) the definition of disability, and (3) valuation—not just how much, but when. Alternatively, clients should consider disability buyout insurance.*

Buy-sell agreements typically address measures to be followed if a business owner dies, as well as a host of possible lifetime "triggering events" that may lead to a sale of the owner's business interest. In my opinion, not enough attention is typically paid to the prospect that an owner may become disabled. Many buy-sell agreements give disability a nod and contain a definition of disability. However, unless the attorney who prepares the agreement makes a genuine effort to have the owners consider the effect of a disability, the subject may get short shrift from business owners. It is not an appealing topic to contemplate. Planning for death is not a day at the beach either, but the inevitable merits a salute not given to the merely possible. Disability is one of those topics that may even make a pessimist engage in wishful thinking: "It won't happen to me."

But happen it does. Most readers of this column are familiar with the statistics pertaining to the occurrence of disability. We are told that a 35 year old is six times more likely to become disabled than to die before age 65. Thirty percent of individuals 35 to 65 years old will experience at least one disability lasting 90 days or longer during their working lives. These statistics are often cited in conjunction with the probability of either a short-term or long-term disability. A disability buyout necessarily means a long-term disability, but the chance that it will occur is still often underestimated or disregarded. So, suppose we discard wishing and hoping as an effective strategy to deal with the prospect of disability. What, exactly, should a business owner consider when a buy-sell agreement is put together?

Disability Buyout versus Disability Income

Let's make sure the owner has the right orientation. Too often, the immediate reaction to the prospect of disability is grounded in contemplating the loss of income. That, no doubt, is an important topic. However, most of us think about replacing income 90 or 180 days after a disability occurs and expect that a return to the working world will follow. Disability buyout planning has a much different time frame. Few shareholders of closely held corporations would want to sell their stock if they expect to work when the disability ends. The waiting period before a disability becomes a triggering event in a typical buy-sell agreement might be one to two years. In order for an owner to be comfortable with the idea that a disability amounts to an offer to sell, he must be very sure that he would not resume working after a disability occurs.

The sale of stock by the disabled owner of a corporation generally represents a point of no return. Thus, it is important to identify that a disability is permanent when a buyout situation occurs. In contrast, a short-term disability may cause the flow of income to be suspended but would not warrant the sale of an owner's interest.

Definition of Disability

Perhaps the true starting point in the discussion of what constitutes a disability for purposes of a buy-sell agreement is to recognize that the occurrence of disability may not be a triggering event for certain owners. A definition of disability generally refers to whether an owner can work in the business. If an owner is a passive investor, the cessation of services rendered because of disability may not amount to much. Also, in the case of family-owned businesses, the disability of an owner may be less likely to prompt the sale of the owner's interest. A disability may lead to a spouse becoming a de facto owner, standing in for the disabled owner as larger decisions are required. In that case, the occurrence of disability may not be a triggering event in which the shares of a corporation, for example, would be offered for sale under a buy-sell agreement.

However, when disability is a triggering event, the need for an effective definition of disability is fundamental. Typically, the definition of disability may be premised on the conclusion of one or more physicians, beginning with the owner's personal physician, that the owner is disabled so as to be unable to continue providing services to the business on a permanent basis. If the business has more than one owner, the other owners or the entity may require a confirmation of disability by a physician of their choice. If the doctors disagree, they may select a third doctor whose opinion will be final.

Alternatively, a definition of disability may be tied to an external standard, such as whether the owner is disabled according to the definition provided under a disability buyout insurance policy. Of course, that is most meaningful when the respective insurance policy pays a claim for coverage. Incidentally, having a definitive external standard may be a very good reason for buying a policy, even if it's only a small one that provides a down payment on a purchase. Other standards could be used such as permanent disability for Social Security purposes (may be a difficult standard to satisfy and arbitrary in its determination, not necessarily a good idea). Sometimes a standard of functional nonperformance may be used: for example, a disabled owner is not able to perform his/her usual duties for at least 20 hours in any week during a one-year period. As is the case for disability income insurance, a disability buyout policy often depends upon whether the insured can no longer perform his/her own occupation rather than whether the insured may engage in any form of gainful employment. The communication with clients about a suitable definition may feel a bit tedious, but the effort to get it right will be far less stressful than subsequent haggling about whether an owner is disabled because no one had a clear understanding of the definition of disabled in the buy-sell agreement.

Valuation: Not Just How Much, but When?

In determining value for the sale of a corporation's stock, it may be challenging enough to develop the right formula or precise number that will satisfy all parties concerned. Triggering events other than disability present no problem in deciding when the valuation event occurs—the shareholder's death, the date when a shareholder terminates employment, etc., are self-evident. However, a disability event inherently has a waiting period that must pass before the disability itself can qualify as a triggering event.

The momentous nature of a sale of a shareholder's stock may mean that fully two years (or more) will pass before the shares are deemed to be offered on account of the disability. After all, if a shareholder develops a medical condition but returns to full-time employment several months later, the sale of shares would be premature. The problem can be solved by a provision in the buy-sell agreement that deems the triggering event to occur when the waiting period ends. At that point, the fact of disability is confirmed, the shares may be offered for sale, and the corporation or the other shareholders may buy the stock of the disabled shareholder. (The buy-sell agreement may provide that the corporation or the other shareholders have an option, or an obligation, to purchase the shares of the disabled owner.)

There are several points and counterpoints that the parties to the buy-sell agreement should consider if they would not have the purchase price determined until the waiting period ends (a method that I endorse). The value of the business may drop substantially because of an owner's disability. Salary payments may continue to be made to the disabled shareholder if the latter does not have sufficient disability income insurance. However, many closely held business owners may receive a relatively modest salary, with a more substantial bonus paid at the end of the year. Perhaps the bonus is considered for purposes of disability income coverage, perhaps not. In addition, the corporation or LLC may have had to hire someone (or more than one) to replace the disabled shareholder.

In any event, the profitability of the business may be diminished because of the disability. Some advisors worry about whether the healthy shareholder may let the business value falter somewhat to reduce the price that will be set at the end of the waiting period. If that's a concern (and maybe, even if it isn't), the agreed value could be determined at the outset of disability rather than at the end of the waiting period. For example, if a two-year waiting period were in effect, no triggering event would occur until the two-year period ended after the onset of disability. However, rather than specifying the agreed value after the two-year period, the value could be the figure that was effective at the onset of disability or at some other specified time, such as one year after the onset. Perhaps the best method in a given situation is to use a formula that calculates the average, or a weighted blend, of the value at the onset of the disability, and the value a year later, and two years later, as the parties may decide.

Disability Buyout Insurance

For better or worse, a limited number of insurance companies offer disability buyout insurance coverage. Typically, coverage is no longer available after an owner reaches age 65 (and periodic reduction in coverage may occur between ages 61 and 65). A waiting period (also called an elimination period) of 12 to 24 months may apply. In order to qualify for a benefit, an individual must be totally disabled, which means that the insured cannot perform the regular and substantial duties of his/her occupation, is not currently working in the business at all, and is under a physician's care with respect to the condition causing the impairment. The benefit may be paid in a lump sum or in installments over several years.

In order for a disability buyout benefit to be paid, when the insured becomes disabled, he or she must have an ownership interest in the business and must have been actively employed in the business for at least 30 hours per week during nine of the preceding 12 months. Typically, a valid buy-sell agreement must be in effect as of the end of the elimination period, under which the owner of the policy (the co-owner or the business entity) is required to purchase the owner's business interest. The benefit to be paid isn't necessarily the maximum benefit under the policy. Instead, it may be the least of 1) the maximum benefit payable under the policy, 2) the fair market value of the insured's interest, or 3) the purchase price of the interest. The fair market value may require verification by an independent CPA. It should be noted that the definition just described makes it incumbent upon the owners of the business to keep the buy-sell agreement updated with a current value that corresponds to the purchase price payable under the agreement. Ensuring that current values are in effect is critical for buy-sell agreements generally, and even more when a disability occurs.

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