Manulife Financial

CONCEPTually Speaking

From the Advanced Sales Unit of
Manulife's Tax & Estate Planning Group

Should a critical illness trigger a buy/sell agreement? Consider these issues

A shareholders' agreement captures the intention of shareholders about their relationship with one another and their corporation. A well drafted shareholders' agreement can address a variety of topics and in doing so prevent potential misunderstandings or issues between shareholders. An important component of a sound shareholders' agreement is buy/sell provisions which allow for the orderly transfer of shares upon retirement, disability, death, bankruptcy or matrimonial breakdown.

In general, most business advisors would agree that life insurance is the most efficient means of funding a buy/sell agreement on the death of a shareholder. But what happens if a shareholder has a heart attack or is diagnosed with cancer but does not result in their death? Should this trigger the buy/sell agreement and can critical illness insurance be used to fund the buy-out?

Yes. But it's not that simple. There are always issues to consider.

First, you must determine whether or not critical illness is a reasonable triggering event for the buy/sell. With death, that decision is fairly easy. With a critical illness, what happens if the shareholder recovers and wants to remain an active shareholder of the business? If the corporation purchases critical illness insurance and a claim is paid, should the agreement require that a buy-out takes place? Should there be a timeframe built into the agreement that allows for recovery before a buy-out occurs? The shareholders may not wish to trigger a mandatory purchase of their shares on the diagnosis and survival of a critical illness.

The actual critical illness may also present a problem. What happens if the shareholder is diagnosed with a critical illness which is not covered by the critical illness policy? Where will the money come from to facilitate the buy-out?

Buy-sell provisions may be triggered on the disability of a shareholder. Disability may be defined in the shareholder's agreement or with reference to definitions found in disability insurance policies. It should be noted that critical illness insurance pays benefits on diagnosis but after a specified waiting period. There is no disability requirement, although this can result. When funding disability buy-out clauses, critical illness insurance may not be an appropriate substitute. Disability may be caused by things other than a critical illness.

Finally, can the critical illness policy provide the amount of funding required to facilitate the buy-out? The maximum amount of critical illness coverage insurers will allow on any life is approximately $2 million. As a result, a shortfall in cash may occur if the shareholder has shares worth more than $2 million.

Given these issues, shareholders have to think carefully about whether or not they wish critical illness to be a triggering event for an optional or mandatory buy-out.

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