

# Disability Buy-Out

(HH703 | HH794)



# Disability Buy-Out (HH703 | HH794)

This section provides detailed information on the features, rider and underwriting of the Disability Buy-Out (DBO) insurance policy. Our illustration system calculates rates for you.

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# Disability Buy-Out (HH703 | HH794)

The objective of Disability Buy-Out (DBO) insurance is to provide funding for the purchase of a business owner's interest under a buy-sell agreement, by one or more other owners in the same firm, in the event of a long-term total disability.

## Target market

- The best prospects for DBO are businesses with two or more owners who are full-time, active and key to the continuation of the business. A one person or single owner DBO is considered with the HH794 product under a One-Way Buy-Out concept (an industry game-changer!).
- DBO works best for small businesses rather than large ones, where the principals can more easily fill in if another principal becomes disabled.
- A three-person professional partnership, with equal ownership, is an example of an ideal DBO situation.

Other types of businesses are eligible, too. However, the ownership details and objectives of the buy-out must be looked at more closely. Where these factors are favorable, DBO cases between two or more non-related principals are generally good risks. Business owners with large differences in age may represent an uninsurable Disability Buy-Out risk.

There are additional guidelines when the buy-out is between close relatives because of possible anti-selection. Familial cases (spouses, parent-child) generally are not considered. Other family relationships (siblings, cousins, etc.) may be considered.

**Note:** California business products differ and are not part of the Series 700 portfolio. DBO is not available in Massachusetts.

## Buy-out methods

The client's attorney and/or financial advisor should assist the client in determining the appropriate buy-out method. The number of owners, their ages and desired tax results will all affect the decision on the structure of the agreement.

- Cross purchase, stock redemption and trusted buy-sell agreements are all eligible.
- Trusted buy-sell arrangements are also available for C corporation owners.
- Sample buy-sell agreements are available on [advisors.principal.com](http://advisors.principal.com).

**Note:** A buy-sell agreement is not required in order to purchase DBO insurance (unless a One-Way Buy-Out agreement is established, page 6-13), but one must be in place at the time of a disability claim. In the state of New York, the buy-sell agreement must be in place before purchasing DBO insurance.

## Occupation classes/policy forms

- Occupation classes: 6A<sup>1</sup>, 5A, 5A-M, 4A, 4A-M, 3A, 3A-M, 2A and A.
- Premiums, benefits, and the availability of riders vary by occupation class. The premium class may be standard or an extra percentage of standard.
- The "M" subcategory (5A-M, 4A-M, 3A-M) is being used to cap the maximum issue and participation limit and may have additional requirements for optional riders.
- Policy Form: Disability Buy-Out HH703 (HH735 in NY) or HH794.

<sup>1</sup> The 6A occupation class is for Disability Buy-Out (HH794 policy) in approved states. In these states, the Select Occupation Discount is not available. For a complete listing of state approvals, visit [principal.com/distateapprovals](http://principal.com/distateapprovals).

### Premium rates

- Premiums are dependent on many factors age, occupation class, tobacco status, benefit factor, elimination period, termination date, riders, features and others.
- Minimum annual premium required: \$200 (pre-discounted).
- Minimum earned income is \$15,000/year as indicated on federal tax returns. Verification of personal earned income is not required unless requested by your DI underwriter.
- Policies issued with gender-specific<sup>1</sup> rates.

<sup>1</sup>Written state of Montana requires gender-neutral rates.

✓ **Tip:** Leverage the illustration system to automatically calculate premiums.

### Eligible discounts<sup>2</sup>

Discounts are not available in all states, are not all stackable with each other and may require pre-approval. Certain guidelines and restrictions may apply.

- 10% Association
- 20% Multi-life
- 5% Preferred Business Owner (HH794 only)
- 10% Select Occupation (HH703 only)

<sup>2</sup> See page 8-4 (Multi-life), 11-2 (Association), 12-5 (Select Occupation), 6-9 (Preferred Business Owner).

### Issue ages

- Issue ages: 18-60 (18-55 for One-Way Buy-Out—HH794 only).
- Issue age has a direct impact on the premium paid for coverage.
- Older the client, the higher the premium; use age as of last birthday.
- Backdating to save age is allowed for a maximum of 30 days prior to the application date.

### Elimination periods

- The elimination period (commonly referred to as a “waiting period”) is the number of days the insured must wait before benefits begin to accrue.
  - Benefits are paid one month after satisfying a policy’s elimination period.
  - Elimination periods: 365, 540, 730 days.
- ✓ **Tip:** When combining Overhead Expense (OE) insurance with Disability Buy-Out (DBO) insurance, recommend the client matches the OE benefit period to the DBO elimination period when possible.
- ✎ **Note:** The shorter the elimination period, the higher the premium.

### Termination dates

The termination date is the date DBO coverage is provided through. Available termination dates:

- To age 65 policy anniversary
- To age 67 policy anniversary (HH794 only)

### Payment methods

There are three payment methods available:

- Lump sum
- Monthly installment
- Combination of lump sum and monthly installment

Benefit factors available on the monthly installment and combination payment methods are 24, 36 and 60 times.

The benefit factor multiplied by the maximum monthly benefit equals the maximum aggregate benefit. The maximum aggregate benefit is the maximum amount payable for any total disability.



# Policy description (HH703 | HH794)

This policy description is a general summary. All features, provisions and riders may not be available in all states and may be subject to state variations. Refer to your state policy and rider forms for the full definition of all policy provisions, benefits, limitations and exclusions.

## Renewability

- Renewable to age 65 or to age 67.<sup>1</sup>
- During the term of the policy, and while this policy is in force, we cannot change the policy or change the premium rate.
- The term of the policy continues until the earliest of the:
  - Insured’s age 65 or 67<sup>1</sup> policy anniversary; **or**
  - Date the insured terminates active full-time employment with the firm for any reason other than total disability; **or**
  - Date the buy-sell agreement is terminated or executed; **or**
  - Date the maximum aggregate benefit or the final buy-out expense payment is paid; **or**
  - Date of the owner’s written request to terminate the policy; **or**
  - End of the grace period; **or**
  - Death of insured or owner:
    - 1) Date the owner no longer has ownership interest in the firm; **or**
    - 2) Date the owner terminates active full-time employment with the firm.

HH703 state variation—NY.

HH794 state variation—VA.

Not available in the written state of MA.

<sup>1</sup>Available in approved states for policy series HH794.

## Definition of total disability

When due to injury or sickness, the insured:

- Is unable to perform the substantial and material duties of his or her occupation,
- Is not working in any other occupation for the firm, and
- The requirements of the claim information section of the policy are satisfied.

HH794 State variation—MO, MD, VA.

## Benefit payable (HH703)

Benefit will become payable to the owner the later of the end of the elimination period or the date a buy-out expense is incurred if:

- The insured incurs a total disability while engaged in active full-time employment in the firm;
- The insured has an ownership interest in the firm when the buy-out expense is incurred;
- The owner incurs a buy-out expense in performance of the terms of the buy-sell agreement that is in force at the time the total disability begins; **and**
- The requirements of the claim information section of the policy are satisfied.

We will refund any excess premium paid for the 12 months prior to the date of total disability if the total buy-out expense amount incurred is less than the benefits shown on the current data pages.

We will waive the requirements of total disability during the Insured’s lifetime after a payment of a buy-out expense benefit has been made.

If the insured has buy-out expense coverage with another company in effect at the time of total disability, the benefits of this policy will be adjusted to a proportion equal to the percentage this policy’s benefits bears to the total amount of buy-out expense coverage. The total benefits provided by this policy and any other buy-out expense coverage in effect at the time of total disability will not exceed the total buy-out expense incurred.

### After age 61, benefits are reduced as follows:

Age when disabled	Maximum benefit
Under 61	100%
61-62	80%
62-63	60%
63-64	40%
64-65	20%
Over 65	0%

HH703 State variation—NJ, NY.

### Benefit payable (HH794)

Benefit will become payable to the owner the later of the end of the elimination period or the date a buy-out expense is due if:

- The insured becomes totally disabled while engaged in active full-time employment in the firm; **and**
- The insured has an ownership interest in the firm when the buy-out expense is due; **and**
- The owner is responsible for a buy-out expense in performance of the terms of the buy-sell agreement that is in force at the time the total disability begins; **and**
- The owner is engaged in active full-time employment for the firm; **and**
- The requirements of the claim information section of the policy are satisfied.

We will refund any excess premium paid for the 12 months prior to the date of total disability if the total buy-out expense amount incurred is less than the benefits shown on the most recently issued Data Pages.

We will waive the requirements of total disability during the insured’s lifetime after a payment of a buy-out expense benefit has been made.

If the Insured has buy-out expense coverage with another company in effect at the time of total disability, the benefits of this policy will be adjusted to a proportion equal to the percentage this policy’s benefits bears to the total amount of buy-out expense coverage. The total benefits provided by this policy and any other buy-out expense coverage in effect at the time of total disability will not exceed the total buy-out expense due.

After age 61, benefits are reduced as follows:

Age when disabled	Maximum benefit
Under 61	100%
61-62	80%
62-63	60%
63-64	40%
64-65	20%
Over 65	0%

After age 63 on an Age 67 policy anniversary policy:

Age when disabled	Maximum benefit
Under 63	100%
63-64	80%
64-65	60%
65-66	40%
66-67	20%
Over 67	0%

### Full benefit continuation (HH794)

If the client chooses the **full benefit continuation** (cost) feature, the benefits available if the insured becomes disabled within five years of the termination of coverage are not reduced.

This feature is available for those who are insured and under age 55 at time of purchase.



## Exclusions and limitations (HH794)

This policy does not pay benefits for injury or sickness which in whole or in part is caused by, contributed by, or which results from:

- Intentional, self-inflicted injury; **or**
- The insured's commission of or attempt to commit a felony or the insured's involvement in an illegal occupation or activity; **or**
- The suspension, revocation or surrender of the insured's professional or occupational license or certification; **or**
- Active military service during a military action or conflict; **or**
- Loss we have excluded by name or specific description in any attached rider or endorsement.

No benefits are payable for any period of total disability in which the insured is incarcerated in a penal or correctional institution for a period of 30 consecutive days or longer.

No claim for total disability or loss which begins within two years after the effective date of coverage and results from a pre-existing condition not disclosed or misrepresented in the policy application will be paid.

If the insured is residing or staying outside the U.S. during any period of total disability, additional requirements are applicable:

- Evidence submitted for the claim will be required to be translated by the U.S. embassy and contain their seal.
- The insured may be required to return to the U.S. at a frequency we deem necessary to substantiate the claim at his or her or the owner's expense.
- The insured or owner must notify us in advance of the insured's return to the U.S. and the change of address.

There may be other exclusions or limitations in the policy in addition to those stated above. Additional exclusions or limitations, if any, will be described in riders or endorsements attached to the policy. Examples include, but are not limited to Modified Coverage rider, Additional Exception riders, etc.

HH794 State variation—CT, DC, GA, IA, IL, KY, LA, MD, MN, MO, NC, ND, NE, NJ, SC, SD, TX, VA, WI, WY.

## Death benefit

- Pays a lump sum benefit of two times (three times for policy series HH794) the maximum monthly benefit if the insured dies after satisfying the elimination period while monthly benefits are being paid.
- Benefit is payable in addition to any other policy benefits.
- This benefit is not available with the lump sum payment method and is restricted in some states.

HH794 State variation—GA, KS, LA, MD, MN, SC.

HH794 Not available—IL, NJ.

## Exchange privilege

- On or before age 60, the Insured may exchange the policy for any individual Disability Income policy based on our then current underwriting guidelines, without medical evidence of insurability.
- The new policy will:
  - Not feature a maximum benefit period more than two years and the elimination period will be 90 days or greater.
  - Have a maximum monthly benefit lesser of \$2,500 or the maximum amount we are willing to offer under our current underwriting guidelines.
  - Contain any exclusions, rating, or limitations contained in the current DBO policy.

HH703 Not available—NY.

HH794 State variation—MI.

## Legal/accounting fee benefit

- Provides the owner up to a maximum of \$3,000 in legal and accounting fees if such fees are incurred in performance of the buy-sell agreement as a result of the Insured's total disability.
- Benefit payable in addition to the maximum aggregate benefit.

### Military suspension

- Suspends the policy if the insured enters the military service on a full-time active-duty basis.
- No premium is due during the service and no policy benefits are provided during that time.
- The policy can be restored (same as before the suspension), if:
  - Active duty ends within five years of the suspension; **and**
  - The owner requests the suspension to end within 180 days of the end of service.

HH794 State variation—IL, MD, NJ, VA.

### Reinstatement

- Allows the policy to be reinstated anytime within one year after its termination, subject to our then current underwriting guidelines.
- A formal reinstatement application may be required.
- A reinstated policy covers disabilities from a sickness that first manifests itself more than 10 days after reinstatement date, or an injury occurring after the reinstatement date.

HH794 State variation—IL, IN, KY, MD, MN, NE, NJ, SC, VA, WI.

### Transfer privilege

On or before age 60, the Insured may become the insured under any form of buy-out policy available without medical evidence of insurability if:

- The policy has been in force for at least two years; **and**
- The policy terminates because the insured ends active full-time employment with the firm; **and**
  - The insured starts active full-time employment for another firm in which the insured has an ownership interest; **and**
  - The insured is not totally disabled and is not receiving benefits under the policy.

Underwriting requirements, other than medical, must be met. The benefit limits of the new policy cannot be greater than those provided by the current policy, and will contain any exclusions, rating, or limitations contained in the current DBO policy.

HH703 Not available—NY.

HH794 State variation—MI.

### Waiver of premium benefit

If insured is disabled, after the lesser of 90 days or the elimination period, we will:

- Refund the monthly pro-rata portion of any premium paid for coverage after the date a continuous disability began; **and**
- Waive the payment of premiums which come due during the continuous disability.

Premium payments will begin on the next premium due date after the insured is no longer receiving benefits under this policy or the disability ends.





## Exclusions and limitations (HH703)

- This policy does not pay benefits for injury or sickness which in whole or in part is caused by, contributed by, or which results from:
  - Intentional, self-inflicted injury; **or**
  - Your commission of or your attempt to commit a criminal act, or your involvement in an illegal occupation or activity; **or**
  - The suspension, revocation or surrender of your professional or occupational license or certification; **or**
  - Active military service during a military action or conflict.
- No benefits are payable for any period of disability in which you are incarcerated in a penal or correctional institution for a period of 30 consecutive days or longer.
- A sickness resulting from normal pregnancy will be covered if the elimination period is equal to or greater than 90 days.

There may be other exclusions or limitations in the policy in addition to those stated above. Any additional exclusions or limitations (if any) will be described in riders or endorsements attached to the policy. Examples include, but are not limited to Modified Coverage rider, Additional Exception riders, etc.

HH703 State variation—ID, MT, NY, PA, UT, VT.

## Preferred Business Owner Discount (HH794)

- Available in approved states for HH794 policy.
- 5% discount on DBO insurance when the owner buys or has other IDI or life insurance from Principal in place.
- Stackable with either the multi-life or Association Discount.<sup>1</sup>

<sup>1</sup>See page 8-4 (multi-life) and 11-2 (Association).

# Benefit Update

## Benefit Update (BU)/BU Valuation<sup>2</sup>

- No cost rider on all standard premium policies.
- Allows owner to purchase increased policy benefits every three years without evidence of insured's medical insurability.
- Occupation classes: All (if at least 75% of eligible coverage is purchased at issue).
- Issue ages: 18-55.
- Policy benefits can increase every three years without medical evidence of insurability.
- An advance option is available for the HH794 policy when the owner has a 20% increase in the buy-out expense since the last review.

At three year intervals beginning with the policy date, Principal sends the owner correspondence regarding the opportunity for an informal business valuation and benefit (BU) review.

- The owner must return a complete application and financial documentation.
- There is **no cap** (or age restrictions) for benefit increases up to maximum issue and participation limits. A competitive advantage.
- At each BU option, the owner must accept a minimum of 50% of the additional DBO benefit offered or the rider will be removed from the policy.

Producers are kept up-to-date with correspondence through the IDI Benefit Update Activity Report available on our advisor website. A weekly e-mail notification is sent (prompting login) when there is any BU activity on your in-force book of business.

<sup>2</sup>Benefit Update Valuation rider for HH794 policy.

HH717 state variation—NY.

HH795 state variation—AK, VA.

# Underwriting guidelines

## Maximum issue limit<sup>1,2</sup>

Occupation class	6A <sup>3</sup> , 5A, 4A, 3A	5A-M, 4A-M	3A-M	2A	A
Elimination period	Lump sum				
365 days	\$1,500,000	\$1,250,000	\$1,250,000	\$750,000	\$250,000
540 days	1,750,000	1,500,000	1,500,000	1,000,000	500,000
730 days	2,000,000	1,500,000	1,500,000	1,250,000	750,000
Elimination period	Monthly benefit factors 24 and 36				
365 days	1,750,000	1,500,000	1,250,000	1,250,000	500,000
540 days	2,000,000	1,500,000	1,500,000	1,500,000	750,000
730 days	2,500,000	1,500,000	1,500,000	1,750,000	1,000,000
Elimination period	Monthly benefit factor 60				
365 days	2,000,000	1,500,000	1,250,000	1,500,000	500,000
540 days	2,500,000	1,500,000	1,500,000	1,750,000	750,000
730 days	3,000,000	1,500,000	1,500,000	2,000,000	1,000,000

**Note:** When a combination of lump sum and monthly payments is desired, the aggregate benefit limit (lump sum plus monthly payments) is the maximum issue and participation limit for the monthly benefit factor selected. The lump sum amount of the combination cannot exceed the lump sum limit for the selected elimination period and occupation class.

**Example:** A combination of lump sum with a 365 day elimination period and a benefit factor of 24 is desired by two optometrists (6A<sup>3</sup>) with an aggregate benefit of \$1,750,000 each (the business valuation equals \$4,000,000).

The maximum issue and participation limit (per the table) is \$1,750,000. Of this amount, each optometrist may have any number of combinations, as long as the lump-sum amount does not exceed \$1,500,000.

For Benefit Update or Benefit Update Valuation offers, the maximum issue and participation limit is based on the current limit of the insured's current occupation.

<sup>1</sup>Guidelines differ for One-Way Buy-Out.

<sup>2</sup>Participation limits are 150% of issue limit.

<sup>3</sup>Available in approved states for the HH794 policy.



### What income documentation is required?

[Refer to Age and amount guidelines section.](#)

### Financial verification requirements

The required documentation is:

- Profit and loss (income) statement year-to-date.
- Past two years business federal income tax return.
- Current balance sheet.

### General guidelines

- Contact your DI underwriter for businesses valued over \$20 million to review unique risk characteristics.
- Closely-held family businesses involving siblings or cousins are typically eligible for DBO. However, due to the increased risk of anti-selection associated with family relationships, husband-wife and parent-child businesses are not considered.
- The insured may not be the owner of the policy.
- If the proposed insured is overinsured for personal Disability Income insurance, Disability Buy-Out coverage is not available because there is less incentive to return to work (e.g. claim duration might be longer than otherwise be expected).
- If adjusting a DBO policy after age 60, please contact your DI underwriter.

### Number of business owners

**Minimum number of business owners required: 2 (in most cases).**

- Insurable DBO cases need to represent an arms-length transaction between **two or more** current, full-time, active owners of the business.
- Businesses which have more than one owner, but which desire DBO on only one owner, are not eligible because of an increased element of anti-selection.
- Single person or sole business owners are eligible when an established agreement is in place to fund a One-Way Buy-Out agreement (HH794 only). See page 6-13 for details.

Occupation classes	Maximum number of business owners
6A <sup>1</sup> , 5A, 5A-M, 4A and 4A-M	10
3A, 3A-M and 2A	8
A	6

### Additional considerations:

- Business owners with at least 5% ownership interest in the business are eligible if there are at least four active owners and no one owner has more than 80% ownership interest; otherwise, 10% ownership is required.
- Business owners must be actively working on a full-time basis for the business named in the application.
- All eligible owners of the business must apply for coverage in the same proportion as their business ownership.
- The insured may not be the owner of the policy.

### Minimum number of years in the business:

- Service professionals (i.e., M.D., CPA, attorney)—1 year
- Other business owners—3 years

<sup>1</sup>Available in approved states for the HH794 policy.

## Business valuation

The underwriter’s purpose in evaluating the DBO risk is to determine if the amounts applied for are reasonable in relation to the value of the business.

- This is the most important process of underwriting Disability Buy-Out coverage.
- The process is not an exact science; rather, it is based on the underwriter’s assessment of economic and financial conditions, industry and market data, financial condition of the business being insured and common sense.
- The underwriter is not acting as a business appraiser or attempting to establish a true market value or sale price for the business.
- The process is comparable to the valuation conducted by a bank during a mortgage application.
  - As part of the mortgage process, the bank conducts an appraisal (valuation) of the property involved.
  - The bank is not looking to set a sale price for the property but simply to determine a reasonable value in the event of a forced sale during a foreclosure.
  - The Disability Buy-Out valuation follows a similar course by attempting to assess a reasonable value for the business in the event of a forced sale resulting from the disability of a shareholder.
- ✓ **Tip:** Don’t forget, Principal offers complimentary business planning services for owners, including buy-sell reviews and informational business valuations. These informal business valuations conducted by Principal can be used in the underwriting process.

## Valuation Definitions

**Valuation.** A multiple of the earned income of all of the owners plus book value. To determine the value of a business, it is important to have an understanding of the following definitions:

- **Book value (net worth).** Total assets minus total liabilities at the beginning of the year underwriting reviews. This information is found on the balance sheet.
- **Goodwill.** An intangible asset of a business (i.e., customer list, location, reputation) which is generally not carried on the balance sheet but is a factor in the business valuation. The factor typically ranges from 1-5. The majority of businesses use a factor of 2-3.

## Valuation method

The following method is used to determine business valuation for DBO insurance purposes.

100% owner’s salary + business profit x goodwill multiplier<sup>1</sup> + book value = DBO business value.

**Example:** An architecture firm with two owners and total owner compensation of \$200,000; business profit of \$100,000 and book value of \$150,000.

$(200,000 + 100,000) \times 3^1 + 150,000 = \$1,050,000$   
 $\$1,050,000 / 2 \text{ owners} = \$525,000 \text{ of DBO insurance per owner}$

<sup>1</sup> The multiplier selected in all scenarios should be based on the overall factors of the case, i.e., earnings trends, number of years in the business and the nature of the business.

## One-Way Buy-Out (HH794)

The objective of the One-Way Disability Buy-Out (DBO) is to provide the key employee the ability to fund the buy-sell agreement with the owner of the business in the event of the business owner's long term total disability. Principal is the only IDI insurance carrier to offer this solution.

### Target market

Sole proprietorships are a popular business structure in the U.S. and span a range of industries—from construction to retail to professional services. We recommend targeting:

- Professional service-related companies, such as architecture, healthcare systems, law, dentistry, engineering, accounting and technology.
- Profitable, growing businesses with gross revenues of \$500,000 or more

### Buy-out methods:

- Cross purchase
- Purchase or sale agreement

Occupation classes: All

Issue ages: 18—55 (owner and insured)

Maximum aggregate benefit: \$1,000,000

### Financial Documentation:

- Prior 2 years federal business tax returns
- Current year-to-date profit and loss statement and balance sheet for the firm

### Agreement Documentation:

- Cross purchase is the type of buy-sell agreement required.
- The buy-sell agreement must be in place at the time of application and be reviewed through our business and advanced solutions team.

**Note:** There are different requirements and underwriting limits for the One-Way Buy-Out, but the HH794 policy premium rates and features remain the same.

