



synergy **guide**

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# Buy-Sell Agreements



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## PRESERVE VALUE AND PREVENT CONFUSION

# Is Your Business Protected from the “Terrible Ds”?

The Terrible Ds are Death, Disability, and Divorce. No one likes to talk about these three what-ifs, yet they happen all the time. If you are the co-owner of a valuable business entity (corporation, partnership, or LLC) and one of the Ds happens to you or one of your co-owners, your business could be torpedoed by the courts, the tax man, the heirs, or an angry ex-spouse.

Maybe you’ve heard about buy-sell agreements but haven’t had time to look into them. Or it’s something you’ve dismissed as not applicable to your circumstances. However, if you’re in business with co-owners, you should anticipate the strong possibility of your business derailing unless you have an agreement in place before disaster strikes.

You’ve worked too hard for too long to see your business disrupted.

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### **Not having a buy-sell agreement for your business is like not having a will for your estate.**

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When something happens, and it usually does, you want to make sure your business asset, which represents your income and a good portion of your financial estate, will remain secure through any storm.

#### **Imagine this scenario:**

Your business partner dies in a traffic accident. Immediately, your business is involved in estate proceedings, hampering the ability of your company to conduct business as usual. You and your business are caught up in the details of your partner’s will, if he or she has one, and must answer questions about the true market value of your business. The very real possibility now exists of having to liquidate the business to pay your partner’s interest to his or her survivors...which also creates



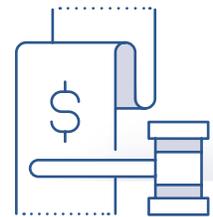
#### **TERRIBLE Ds:**

- 1. Death**
- 2. Disability**
- 3. Divorce**

a tax nightmare...or requires you to find a way to pay your co-partner's estate in a timely manner. Is this a scenario you've anticipated?

**Here's another scenario:**

You or one of your co-owners has tried desperately to save your marriage, but there is no recourse except divorce. This means splitting the estate...and splitting up your company. Now you have the emotional trauma of divorce added to the financial trauma of having to conduct a business valuation, dealing with an inquisitive attorney and an acquisitive ex-spouse. This is a dilemma that might keep you awake at night as you anticipate the heart-rending future.



Why would you want to go through this experience if you didn't have to? Yes, this is another task for your already very busy desk, but consider how important the successful completion of this legal arrangement will be with assuring the continuity of your business when tragedy strikes.

# What Is a Buy-Sell Agreement?

**A BUY-SELL AGREEMENT IS A LEGAL DOCUMENT THAT HELPS BUSINESS CO-OWNERS:**



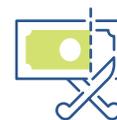
**Transform their ownership interest**

into a liquid asset when required.



**Secure business ownership**

from unwelcome changes.



**Eliminate IRS estate tax valuation**

proceedings during difficult emotional periods.

In effect, a buy-sell agreement can provide the prearranged transition your business will need to settle accounts with a co-owner, ensure that the current co-owners continue without the intrusion of an unwanted new co-owner, and avoid the time-consuming and distracting activity of going through an untimely business valuation required by a court or the IRS.

## Three Kinds of Buy-Sell Agreements

There are really only two kinds, and a third that's a hybrid. Here is some basic information about them:

### 1 Cross-Purchase Agreements

This type of buy-sell agreement creates a contract among all the co-owners that legally obligates the co-owners to buy-out another co-owner's interest in the event of a triggering event. A triggering event can be such conditions as the death, disability, divorce or departure (i.e., retirement) of a co-owner.



**Co-owner is buying out another co-owner**

### 2 Redemption Agreements

A redemption agreement is similar to a cross-purchase agreement except instead of the co-owners buying out a co-owner's interest, it is the business that is legally obligated to buy-out the interest.



**The business is buying out a co-owner**

### 3 Hybrid Agreements

A hybrid agreement combines the benefits of both, offering such options as giving the co-owners the right of first refusal to purchase the interest; if they decline, then the business will purchase the interest. The reverse is also true, in which the business has the first right of refusal with the co-owners obligated to buy the interest if the business entity does not.



**Benefits / flexibility of both**

There is some flexibility with a hybrid agreement such as including a clause stating if neither the co-owners nor the business entity buys the interest, it may then be sold to an outside party.

# Three Primary Goals

A buy-sell agreement assures three essential benefits:



1

## Identifies buyer

Identifies a buyer for the departing co-owner's portion of the business.



2

## Co-owner protection

Ensures that new owners cannot gain access to the business without permission of the current co-owners.



3

## Confirms market value

Confirms the market value of the business for estate and tax inquiries.

If any of these goals was unmet, your business could suffer from the ensuing confusion and rearrangement. If you value these outcomes, you should make an appointment to meet with a professionally trained financial advisor or Certified Financial Planner®, attorney, and/or other appropriate professionals to discuss your unique circumstances.

**These three benefits are very important to the continued vitality of your business.**

# Important Details to Know

As with any legal document, there are a number of items requiring careful review; consult with an attorney familiar with buy-sell agreements.

1.

## Align with other documents

Assuming you already have a business entity with co-owners, the agreement must be aligned with other business documents such as the articles of incorporation, etc.

2.

## Existing contracts

Any pre-existing contracts such as loans or leases should be reviewed to ensure no violation will occur with a buy-sell agreement.

3.

## Other triggering events

Aside from the events (death, disability, divorce, retirement,) careful reflection may reveal other potential triggering events such as bankruptcy, or the loss of a professional license that could mandate the departure of a co-owner.

4.

## Spouses as co-owners

Community property states may make spouses legal co-owners; the laws of your state should be reviewed with an attorney to determine the effect on the buy-sell agreement.

5.

## Identify valuation method

There are several ways to conduct a business valuation, co-owners should establish which method makes the most sense for the business entity, satisfying requirements for the IRS and estate taxes.

6.

## How will the remaining co-owners be paid

Another important detail to determining to the departing co-owner, or his or her estate. This may take the form of a lump sum payment, or periodic payments with previously determined amounts.

7.

## Simultaneous triggering events

Consider what might happen if a triggering event occurs with one co-owner, and then a second triggering event occurs before the first event has been resolved.

8.

## Redemption agreements

Because the business entity is the primary respondent, this can generate complications with federal income tax regulations. Redemption agreements are particularly troublesome for C corporations. Cross-purchase agreements are preferable, so consult your attorney and tax consultant.

# Where Does the Cash Come From?

Life insurance and disability insurance can both be used as tools to offset the expense of funding when a co-owner either dies or becomes incapacitated. In a cross-purchase agreement, the co-owners purchase a life insurance policy on each other's life. When one of the co-owners dies, the survivor receives the death benefit and uses that money to purchase the interest of the deceased co-owner. While the life insurance premiums are not tax-deductible, the death benefit proceeds are free of federal income tax.

In a redemption agreement, it's the business entity which purchases life insurance policies on each of the co-owners, and **the business receives the death benefit proceeds** which then purchase the deceased owner's interest. The death benefit proceeds from a redemption agreement will also be free of federal income tax.

Disability insurance works in a similar fashion. While the premiums are also not deductible, the benefit payments are often free of federal income tax.

When other triggering events occur, such as divorce, bankruptcy, retirement, etc., the remaining co-owners in a cross-purchase agreement will need to personally fund the purchase of the departing co-owner's interest. Smart co-owners will establish an investment fund dedicated to the purchase of the other co-owners' interests so these funds have time to grow and accumulate, should they be needed.

If your business entity has chosen a redemption agreement, and your buy-sell agreement stipulates that **your business will purchase the departing co-owner's interest, then it is the company that will need the funds to pay**. Again, careful planning will alleviate pressure should the business need to make payments to a departing co-owner.



## CROSS-PURCHASE AGREEMENT

Co-owners purchase a life insurance policy **on each other's life.**



## REDEMPTION AGREEMENT

Business entity purchases life insurance policies **on each co-owner's life.**



# The Importance of the Valuation Process

Since the buy-sell agreement is a document that defines how the ownership of a company will be bought and sold among the partners or their heirs, an effective buy-sell agreement must include detailed information about how the value of the company will be determined. Without this information, conflicting interests and imbalanced apportionment could disrupt relationships and even the performance of the company. The company's valuation is a critical task because the biggest unknown is the monetary worth of the company. Without predetermining several significant elements, a huge difference in the value of a company may result. This is no idle matter!

Every business transaction has a buyer and a seller, and the inherent conflict is that the buyer wants to buy low and the seller wants to sell high. Without carefully identifying specific details of the arrangement, the partners may unintentionally sponsor unwelcome results for themselves or their heirs. Partners entering a buy-sell agreement are wise to remember that either partner could become the buyer or the seller in time; a discussion is needed to determine if the partners want to be fair to just one party or to all. Even though the partners may be friends working toward the same expectations, when one of the parties dies or must sell their portion, the original buyer and seller arrangement could be affected by unexpected and competing influences.



**A company's valuation is a critical task because the biggest unknown is the monetary worth of the company.**

## Five Defining Valuation Elements

It is not in the best interests of the partners to have a business appraiser interpreting the partners' intentions. The buy-sell agreement must clearly set the details for the following five elements:



### 1. The Standard of Value

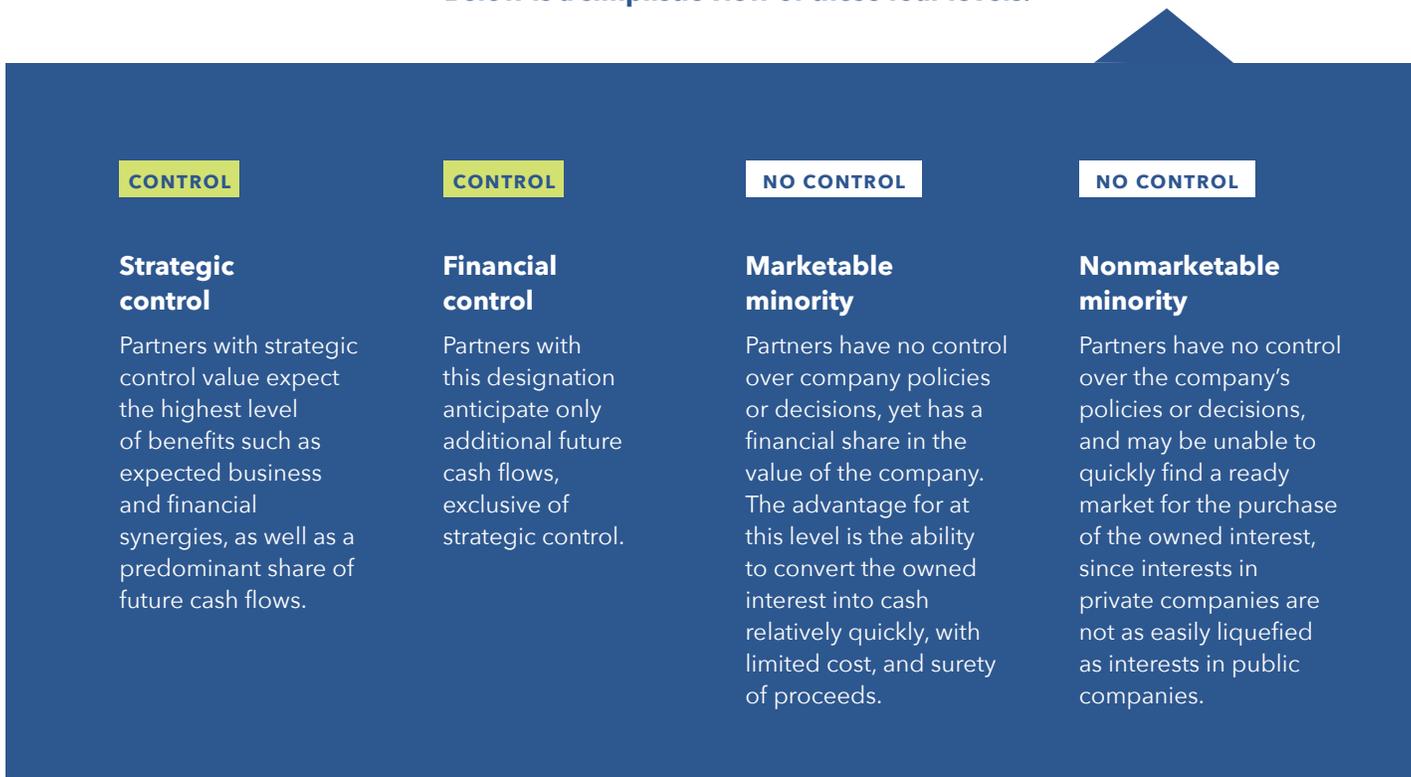
There are several ways to value the monetary worth of a company, such as **fair market value**, **fair value**, **book value**, **intrinsic value**, and **investment value**; based on the standard selected, varying monetary values could result. Business partners typically prefer the most appropriate standard for the highest cash value. If, however, the valuation expert has to use his or her professional judgment because the partners failed to identify the standard of value, the results may not be what the partners intended. Therefore, the standard of value must be very clearly identified in the buy-sell agreement.



### 2. The Level of Value

There are several designations for the level of value a partner can own. A valuation analyst needs to know if there is a **control** or **non-control** level of value, and also if there is a marketable or nonmarketable level of value. These are the four basic "levels" of value, and they apply to all businesses. These levels of value have a hierarchy, and premiums and discounts are applied when calculating a partner's share of influence and the financial value his or her share represents.

**Below is a simplistic view of these four levels.**



As you can see, it is critically important for the valuation analyst to have clear information about the level of value each partner owns...or the ensuing confusion could create circumstances that may be extremely difficult to resolve.



### 3. The “As-Of” Date

**Identifying the date by when a company’s valuation** will be conducted is important because the timing of the valuation could significantly affect the apportionment of the company’s value to the partners. For example, many businesses receive all their cash flow in one or two months, or in a cyclical pattern. If the company receives most of its revenue in one half of the year and not the other, when a partner dies or must sell his or her portion in the low-revenue half of the year, is the partner or the partner’s estate entitled to the revenue for the entire year...or just a portion of the year? This is why the “as-of” date is so important.



### 4. The Appraiser’s Qualifications

The partners should agree on the qualifications of the appraiser. An appraiser should be a **professional valuator certified as a CFA or a CPA**, with credentials from the National Association of Certified Valuation Analysts (NACVA) or the Uniform Standards of Professional Appraisal Practices (UPAP). If the partners hire an inexperienced valuator or someone who is under-credentialed, a huge problem could result. Establishing minimum qualification standards for the appraiser could be a significantly important factor with achieving valuation success.



### 5. The Appraisal Standards

When the company’s valuation is conducted, specific expectations for the process must be followed, and these standards should be written into the buy-sell agreement so there is no room for conjecture. Such details as **gathering specific data, determining the basis of value, identifying the interest being appraised, and specifying appropriate assumptions** are all key factors having a significant impact on the results of the valuation. The methodology of the process should be clearly determined in the agreement.

## Three Other Important Aspects of the Valuation

### 1. The Treatment of Life Insurance Proceeds

Since most buy-sell agreements include life insurance as a funding source, the partners must decide on whether the proceeds from a **life insurance policy will be a corporate asset or a non-corporate asset**. The company's valuation could be affected tremendously, and may also leave one of the partners with an unintended inequity. When life insurance proceeds are not a corporate asset, the result could be a larger monetary value, yet if the life insurance proceeds were a corporate asset, the company's value could be significantly less.

### 2. When to Value

Conducting a periodic valuation of the company is a smart business practice. It's much wiser to test the valuation process and become familiar with the results before being forced to conduct the valuation under pressure when one of the partners is deceased or must sell under duress. **Having a valuation performed every few years** will help the partners identify inconsistencies that could negatively impact the buy-sell agreement when someday it must be activated. This process also gives the partners a baseline so the partners can read the appraisal report and clearly see how the selected protocols affect the outcome. If the partners agree that the outcomes are not as expected, the buy-sell agreement can be updated and made more comprehensive.

### 3. Who to Value

It is often in the best interests of the company **to have a single appraiser**, thus limiting potential conflict. The alternative, which is each partner having their own appraiser, is likely to be divisive as different valuations will almost surely result. Agreeing on a single appraiser, the partners should test the appraiser's abilities with a formal business valuation. This also helps the single appraiser become familiar with the company and the partners' expectations. In later years, the appraiser may no longer be with the selected

#### BUY-SELL AGREEMENT

This Agreement is made as of this \_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_, by and between \_\_\_\_\_ (Company name), a corporation located at \_\_\_\_\_ (Company address) and each of the individuals listed on Schedule A attached hereto (the "Shareholders").

##### ARTICLE I PURPOSE

This Agreement is intended to govern the ownership and transfer of the outstanding shares of the Company (the "Shares") in the event of the death, disability, or other event of a Shareholder.

Each Shareholder hereby agrees to enter into this agreement to: (Check all that apply)

to sell Shares to the Company in accordance with established procedures in the event of a death, disability, or other event of a Shareholder; to sell Shares to the Company in the event of a death, disability, or other event of a Shareholder; to sell Shares to the Company in the event of a death, disability, or other event of a Shareholder; to sell Shares to the Company in the event of a death, disability, or other event of a Shareholder.

##### ARTICLE II RESTRICTIONS ON TRANSFER

Notwithstanding to whom the Shares are transferred, the parties will not be bound by any transfer of the Shares unless the transferee is a Shareholder named in this Agreement. Any transfer of the Shares not in accordance with the terms of this Agreement shall be void.

Each Shareholder hereby agrees to execute and deliver to the Company such documents as may be required to carry out the purposes of this Agreement, and to sign and deliver to the Company such documents as may be required to carry out the purposes of this Agreement.

Conducting a valuation every

**3-5**

years is ideal



## In Review

Without the clarifying details of the defining valuation elements, the treatment of life insurance proceeds, and the periodic valuation by a single appraiser, the company's buy-sell agreement could lead to disorder, perplexity, and rancor.

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### **The valuation of your company is the essence of your buy-sell agreement.**

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Synergy Asset Management recommends testing your buy-sell agreement with a business valuation as soon as possible and regularly thereafter so you can ensure that what is written in your buy-sell agreement actually provides the expected results. Instead of waiting 10 or 20 years until the death or departure of one of the partners, conducting a valuation now and every 3 to 5 years will limit the potential for confusion and financial disparity that could otherwise result in contested findings. It truly isn't a good idea to leave this to chance!

# Conclusion

The protection of your business and the health of your financial future are at stake. When you're in business with a co-owner or a group of co-owners, in many ways their fortunes and misfortunes are yours. Because they own a portion of your business, each of you have an obligation to collectively secure the business entity's well-being, as well as a responsibility to assure the continued effective operation of the business when personal, professional, or financial complications arise.

It is natural to expect that events will occur during the course of your business relationship with each other, and it is paramount that a plan exists to counter the negative effects that may befall your business from the variety of life experiences that may jeopardize its solvency. A buy-sell agreement is an exceptional tool to safeguard your interests.

It's not a matter of whether or not an unanticipated event will occur, so it's good business to provide assurance that your business will continue when circumstances affect the lives of your co-owners. A buy-sell agreement assures that the business you have worked so hard to develop and mature will continue to perform effectively during times of significant change.

If you would like to discuss the benefits of a buy-sell agreement for your business, consider the advantages of consulting with a professionally trained financial advisor or a Certified Financial Planner®.



**Protect your  
business with  
a buy-sell  
agreement!**

## It all starts with a conversation.

Give us a call and let's schedule a complimentary meeting.

206.386.5455

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[info@synergy-am.com](mailto:info@synergy-am.com)

# Do You Need a Buy-Sell Agreement?

**1. Does the death or disability of a co-owner concern you?**

Life events can quickly alter the status quo. If one of your business co-owners has a tragic accident, a buy-sell agreement can protect your business from the resulting confusion over ownership.

**2. How will ownership issues be resolved if one of your co-owners has to divorce their spouse?**

If you live in a community property state, the divorced spouse may have rights to your business. The spouse could become a co-owner, or demand a buy-out of his or her interest in the company. Do you want to be subjected to this difficulty, and do you want to get involved with an attorney's inquisitive interruptions?

**3. What will happen if one of your co-owners decides to cash out?**

Either because of retirement, or a changing lifestyle, or a personal issue like an impending bankruptcy, one of your co-owners may decide it's time to go. Is there an agreement already in place that details the process, or is this something you'll figure out on the fly?

**4. What is your business worth, exactly?**

When one of your co-owners has to leave the business, they, their heirs, and the tax man will need to know the exact worth of the business. Most owners think they know...but in a legal transfer of ownership, the exact value will be required. The court mandates that one of several specific processes determine the precise value.

These processes can be time-consuming and disruptive to daily business activities. Wouldn't it be better to get this task completed now, rather than when you are under additional duress?

**5. Does the thought of having a new and unwanted co-owner disturb you?**

It's possible that a lack of preparation can open the door to the presence of an unwanted co-owner... perhaps your co-owner's former spouse, or an heir, or an outside third party. If you're uncomfortable with suddenly having a new co-owner partner, a buy-sell agreement can give you more control over your options.

**6. Is having the cash to buy your co-owner's interest appealing to you?**

With a buy-sell agreement, you can buy life insurance or disability insurance on each other so the cash is available in case of death or other catastrophe. In a redemption or hybrid buy-sell agreement, the business entity makes the purchase, not you. There are other funding options, too.

**7. When the time comes, wouldn't you like to know how the payout will take place?**

You should decide now, rather than later, about making a lump sum payment or prescribed payouts over a specific period of time. When the choice is made now, all co-owners know what to expect and the potential for confusion, ill-feelings, stress-caused errors, lack of time to consider options, and the burden of making difficult decisions at a difficult time are all eliminated.

As you can see, having a buy-sell agreement in place as soon as possible is a worthy idea and can preserve your business's ability to continue efficiently with a minor degree of disruption. No one likes to think about what might happen, and yet it is a real possibility your business could be seriously affected.

## Disclosure

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