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Agreement*

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Characteristics of a Good Buy-Sell Agreement

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The creation of buy-sell agreements involves a certain amount of future-thinking. The parties must think about what could, might, or will happen and write an agreement that will work for all sides in the event an agreement is triggered at some unknown time in the future. This article addresses nine important characteristics of buy-sell agreements that are important for business owners and for attorneys advising them.

What Do Buy-Sell Agreements Do?

Buy-sell agreements are entered into between corporations and their shareholders to protect companies against disruptive, harmful, or nonproductive owners (including divorced spouses, competitors, disgruntled former employees and the like). They also provide protections for shareholders who may, for any number of reasons, depart the company. The estates of deceased owners need protection, as do shareholders who have been terminated, with or without cause.

It is important that buy-sell agreements be entered into while the interests of the parties (the corporation and the shareholders) are aligned, or at least not sufficiently misaligned, that they cannot discuss the business and valuation aspects of their buy-sell agreements. To the extent possible, attorneys should encourage parties to enter into buy-sell agreements or to review their agreements and update them if they are out of date or circumstances have changed.

What is known for certain is that once a trigger event has occurred, the interests of the parties (i.e., the buyer(s) and the seller(s)) diverge and agreement over the pricing and terms of necessary transactions can become difficult or impossible to achieve.

Characteristics of a Good Buy-Sell Agreement

From valuation and other business perspectives, buy-sell agreements generally incorporate several important aspects defining their operation. The list of characteristics of successful buy-sell agreements below is taken from my book, *Buy-Sell Agreements for Closely Held and Family Business Owners*.

Require agreement at a point in time (before trigger events or other dissension) among shareholders of a company and/or between shareholders and the company.

It may seem obvious, but if there is no agreement between the shareholders and the company, then there is no buy-sell agreement. Such agreements must be evidenced by a writing of the agreement and by the signatures of all parties who will be subject to the agreement. Agreement is not always easy to obtain. Shareholders have different backgrounds, financial positions, personal outlooks, and involvement with a business, so agreement is not automatic. However, it is important that attorneys continue to work with clients to encourage agreement and that business owners remain committed to reaching agreement and signing their buy-sell agreements.

The point in time at which agreement is reached is the date of the signing of each particular buy-sell agreement.

Relate to transactions that may or will occur at future points in time between the shareholders, or between the shareholders and the corporation.

When the shareholders of a new venture come together to discuss a buy-sell agreement, it is foreseeable that many things can happen that will trigger the operation of a buy-sell agreement. Owners may quit, one may be fired, another may retire, one could die, still another could become divorced, and another could become bankrupt — to name a few.

The owners can discuss these future potential trigger events and which ones they want to include specifically in their buy-sell agreements. It is important that all owners think seriously about these issues because, at the time a buy-sell agreement is being drafted, no one knows what might happen to him or to her or to any of the other owners. In other words, no one knows who will be a buyer and who will be a seller.

When the owners of an existing enterprise come together to review their buy-sell agreement, they may know that some of the above-mentioned events have already happened in the lives of their fellow owners. They will know if the buy-sell agreement operated satisfactorily, or was triggered at all.

For all owners of all enterprises, discussions about buy-sell agreements reflect a form of future thinking, which is sometimes (perhaps always) difficult. As Yogi Berra famously said: “The future’s hard to predict. It hasn’t happened yet.”

Choices have to be made regarding buy-sell agreements. Ignoring the importance of these documents because it is difficult to future think about them is one choice. Based on over thirty years of working with businesses and business owners, ignoring the issue is not a good choice.

Define the conditions that will cause the buy-sell provisions to be triggered. Most often, business owners think of death as the most likely trigger event for buy-sell agreements. It is actually the least frequent trigger event for most companies.

Trigger events have to be defined specifically. Death is fairly obvious. However, firings can be with or without cause, and

agreements may need to specify what happens in each circumstance. The parties to an agreement must future think a bit to anticipate what could happen and document the agreement appropriately. If this sounds like work, it is.

Determine the price at which the identified future transactions will occur (as in price per share, per unit, or per member interest). Because of the diverging interests of parties following trigger events, this is one of the hardest parts of establishing effective buy-sell agreements. This is why many appraisers and other advisers to closely held businesses recommend appraisal with a pre-determined appraiser as a generally preferable pricing mechanism for substantial business enterprises.

There are buy-sell agreements with fixed prices. Unfortunately, these agreements are seldom updated and are ticking time bombs. For a poster child example of what can happen with fixed price agreements, read here.

Other buy-sell agreements contain formula pricing provisions. Unfortunately, we haven’t seen a formula yet that can reasonably value any company over time with changing conditions at the company, within its industry and markets, in the local, regional or national economies, and in all market conditions and interest rate environments.

Then, there are what we call valuation process agreements, which provide for a valuation process to determine the price. Many agreements have an embedded multiple appraiser process which will not be exercised until the occurrence of a trigger event. These agreements, too, are fraught with potential pitfalls.

We assert that the best pricing mechanism for most buy-sell agreements of successful closely held and family businesses is a single appraiser process where the appraiser is selected by the parties at the outset and provides an appraisal to determine an agreement’s initial pricing. The appraiser is then asked to provide reappraisals each year (or every other year at most) to reset the price for the buy-sell agreement.

Determine the terms under which the price will be paid.

Many buy-sell agreements call for the price determined under their terms to be paid by the issuance of a promissory note by the company. Quite often, the price determined

by appraisal will be the fair market value of the interest. However, many notes defined in buy-sell agreements are not worth par, or their face amounts, so recipients end up getting less than fair market value for their interests.

A promissory note might be worth less than par if it has a below market interest rate for notes of comparable risk. Often, there is no security for promissory notes issued in connection with buy-sell agreements, and no protection against future financings that are subordinated, leaving the promissory note less protected.

Provide for funding so the contemplated transactions can occur on terms and conditions satisfactory to selling owners and the corporation (or other purchasing owners). This element is important and often overlooked.

Life insurance is often considered as a funding mechanism for buy-sell agreements. One big problem is that the only time that life insurance is received is when an insured owner dies. However, death is the least likely trigger event for most companies. Firings, retirings, divorcings, disabilities, and other things happen with far greater frequency.

Funding may come from a promissory note as discussed above. It can also come from outside financing if the company is able to obtain such financing. Sinking funds have their own issues, because a selling shareholder was present while any sinking fund was accumulated, and would likely desire to share in its value.

Satisfy the business requirements of the parties. While buy-sell agreements have much in common, each business situation is different, and unique parties are involved. In the end, legal counsel must draft buy-sell agreements to address the business issues that are important to the parties. Clearly, establishing and agreeing on the key business issues and having them reflected in the agreement can be difficult. If the owners do not reach agreement on key business issues, no attorney can draft a reasonable document for the parties.

All of the potential trigger events discussed above are business issues (and personal issues) for business owners. Other business issues could include the maintenance of relative ownership between groups of shareholders, the admission of additional shareholders, and other issues that

may or not relate directly to potential future trigger events. Some family businesses add clauses in the event of a shareholder's divorce to preclude the shares from being granted to a divorcing spouse who is not of direct lineal descent of the family.

Provide support for estate tax planning for the shareholders, whether in family companies or in non-family situations.

One client of many years has a buy-sell agreement and the family has engaged in significant gift and estate tax planning. Several years ago, the gift tax returns of the owners of a client company were audited. Agreement could not be reached with the Internal Revenue Service, and the matter proceeded on a path towards Tax Court. One of the key issues in dispute was whether the buy-sell agreement met the requirements of IRS Code Section 2703 (b). After much discussion and preparation for trial, agreement was reached that the buy-sell agreement withstood the exceptions (subparagraph (b)) to the general rule of Code Section 2703:

(b) Exceptions

Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

- (1) It is a bona fide business arrangement.
- (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
- (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

As part of the preparations for trial, I was asked to render a supplemental report on behalf of Mercer Capital to assist the court in analyzing the relevant shareholder agreements from business and valuation perspectives. Fortunately, the case settled on the eve of trial with agreement that the relevant agreement satisfied the requirements, and with settlement at the conclusions of fair market value issued by Mercer Capital for the relevant years. The issues raised by the relationship of buy-sell agreements and estate planning are important.

Satisfy legal requirements relating to the operation of the agreements. Buy-sell agreements must be drafted such that they are legally binding on the parties to them. In addition, agreements must be drafted to comply with laws and/or regulations that may be applicable to their operation. Business owners must rely on legal counsel regarding such matters.

Business owners must agree on the business and valuation issues relevant to their buy-sell agreements. However, those agreements must be memorialized by competent legal counsel, who should be involved in the discussions to begin with, together with estate planning counsel, other financial advisers and a qualified business appraiser.

Conclusion

Buy-sell agreements are business and legal documents that are created in the context of business, valuation and legal requirements. We need to engage in future thinking in order that our agreements will withstand not only the tests of time, but also potential challenges from the Internal Revenue Service.



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Mercer Capital is a national business valuation and financial advisory firm founded in 1982. We offer a broad range of valuation services, including corporate valuation, gift, estate, and income tax valuation, buy-sell agreement valuation, financial reporting valuation, ESOP and ERISA valuation services, and litigation and expert testimony consulting. In addition, Mercer Capital assists with transaction-related needs, including M&A advisory, fairness opinions, solvency opinions, and strategic alternatives assessment.

We have provided thousands of valuation opinions for corporations of all sizes across virtually every industry vertical. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement. Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation on behalf of their clients.

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