Your Corporate Buy-Sell Agreement

Tick Ticking Time Bomb or Reasonable Resolution?

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Buy-sell agreements exist in many, if not most, closely held businesses having substantial size and/or value. And they exist between corporate joint venture partners in many thousands of enterprises.

Buy-sell agreements are agreements by and between the shareholders (or equity partners of whatever legal description) of a privately owned business and, perhaps, the business itself. They establish the mechanism for the purchase of stock following the death (or other adverse changes) of one of the owners. In the case of corporate joint ventures, they also establish the value for break-ups or for circumstances calling for one corporate venture partner to buy out the other partner.

Buy-sell agreements (or put agreements in some cases) are more important than most business owners, shareholders and boards of directors realize. I’ve often said that buy-sell agreements are written under the assumption that the other partner is going to die first - and one of the partners is right!

Seeing two different buy-sell agreements recently put the topic at the top of my mind and triggered a couple of memories, as well.
Never Updated

The other day I reviewed a buy-sell agreement that was perfectly fine on the day it was signed by a company's two major shareholders - more than ten years ago. The agreement states that the parties will reset the value each year. Since then, the company has more than tripled in size and value. However, the valuation in the buy-sell when it was signed remains in effect today because it was never updated.

This creates no significant problems - unless something adverse happens to one of the shareholders. In that case, one shareholder would benefit from a bargain purchase price and the other's family would suffer a true economic loss. With this item now in the open, those shareholders are working to update the document as rapidly as possible.

Formula Pricing

Many business owners want to create a formula to establish the pricing if a buy-sell agreement is triggered. And quite a few buy-sell agreements have them, usually with disastrous long-term results. However, this is not uncommon because this is an inexpensive alternative to hiring a business appraiser. Almost anyone can put a few numbers into a formula, whether it calls for book value at the preceding fiscal year-end or 4.5 times a 3-4 5 year (pick one) average EBITDA - less debt, of course. (I’ve actually seen the exclusion of debt to determine equity value omitted as part of the formula!)

The questions is, will formula results be fair for both sides in all circumstances? I won’t prove it here by boring you with multiple examples, but no rigid formula can realistically determine the value of a business over time with changing company, industry, and economic conditions. That's why many buy-sell agreements use an appraisal process.

Three Appraisers

As mentioned above, I reviewed two buy-sell agreements recently. The second agreement involved the use of what I call "one-two-three appraisers, rock!" The drafters of this type of agreement seem to believe that if it is good to retain one appraiser to value a business, it is better to retain two, or even three. As an appraiser, I suppose I should prefer this mechanism. After all, it increases the odds of our firm being hired.

While I don’t know the genesis of this, many buy-sell agreements are written where the valuation mechanism involves multiple appraisal firms. Variations go like this:

1. The buying party shall retain one independent appraiser, and the selling party another. They will both provide valuation opinions. If the values are within 10% or 15% or 20% (pick-a-percent), the price for the buy-sell agreement will be the average of the two. If they are more than pick-a-percent apart, the price will be determined by the average of the third appraiser’s value and that of the one closest to him or her.

2. The buying party shall retain one independent appraiser and the selling party a second. They do not provide appraisals. Rather, it is their job to mutually select a third appraiser. Having been one of the original two appraisers in several situations, I can tell you that this is not as easy as you might think! This third appraiser will provide a valuation of the business (or interest). The third appraiser’s conclusion is the agreed upon transaction value. If you are the third appraiser, that’s an awesome responsibility, one that I’ve undertaken on several occasions.
3. The buying party shall retain one independent appraiser and the selling party a second. Both will provide valuation conclusions which, if close enough together (pick-a-percent), will be averaged. If the conclusions are more than pick-a-percent apart, the original two appraisers shall select a third appraiser. Again, this is not as easy as one might think. The third appraiser must then pick one of the two appraisals as the more correct valuation, and that will be the transaction price. That's pretty dicey, too, and I've done it.

And there are probably other variations on this theme.

A Single Appraiser

There are at least two versions of the single appraiser pricing mechanism.

1. The agreement states that the parties select an appraiser at the time of a trigger event. Some buy-sell agreements provide for the parties to agree on a single appraiser. If you think it is difficult for two appraisers to agree on a third appraiser, it can be even more difficult for two parties with adverse interests - and yes, the interests will be adverse at the moment of a trigger event.

   There is a great deal of uncertainty in this process because neither party likely has any idea how the selected appraiser will work or what their work product will look like. So this process can feel something like a crap shoot to the parties involved.

   Once selected, however, the appraiser provides an appraisal, and that's the price for the transaction. Unless, of course, one party disagrees vehemently with that conclusion and litigation ensues.

2. The agreement states that the parties select an appraiser at the time of the signing of the buy-sell agreement. I have recommended this choice of pricing mechanism for years - with a twist. My suggestion is that the parties retain a mutually agreeable, independent appraiser at the time of the negotiation of the buy-sell agreement. The appraiser provides an appraisal, and the parties agree that this is the initial value for pricing if the agreement is triggered. All parties know the appraiser, see the methodologies they (the firm) have employed, and are comfortable, at the outset, that the valuation is reasonable and mutually agreeable.

   The parties then agree that the selected appraisal firm will reappraise the business for purposes of the buy-sell agreement every (or every other) year or so, and that the reappraisal will re-establish the price for buy-sell transactions. If the appraisal is "stale" at a trigger event (say more than six months or a year or pick-a-period old), the appraiser will reappraise as of the date of the trigger event.

   This form of pricing mechanism has the benefit of relatively greater consistency and certainty for all parties. Appraisal methodologies should be consistent from one appraisal to the next, or else the appraiser should make explicitly clear the reasons for any methodological changes that influence the appraisal conclusion.
More Comments on Structure

It should be clear that the pricing mechanism in a buy-sell agreement can be important to the outcome of a purchase event when it is triggered.

Before concluding this discussion of pricing mechanisms, let's note some of the other important issues that need to be addressed when formulating your buy-sell agreement:

1. **Standard of value.** Will the value be based on "fair market value" or "fair value" or some other standard. These words can have dramatically different interpretations. Some agreements simply specify "the value" of the company or interest. What's an appraiser to do then? Which value? The likelihood of a successful appraisal process diminishes greatly if this critical defining issue is not clear.

2. **Level of value.** Will the value pursuant to the buy-sell agreement be based on a pro rata share of the value of the business or will it be based on the value of an interest in the business? The differences bring minority interest and marketability discounts into potential play, and wide differences in interpretations of value. Two appraisers could agree regarding the value of a business, but if one applies a marketability discount, their conclusions can be significantly different, and confusion results. This is an issue that needs to be crystal clear in your agreement.

3. **The “as of” date for the valuation.** Believe it or not, some buy-sell agreements are not clear about the date as of which the valuation(s) should be determined by appraisers. This can be extremely important, particularly in corporate partnerships and joint ventures when the occurrence of events other than the death of a partner typically establishes a valuation date. We were involved in major litigation a couple of years back where it took two arbitrations and several nationally known appraisers to resolve what was a dispute over the appropriate valuation date. Fortunately for our client, the arbitration panel agreed with our interpretation of the buy-sell agreement from a valuation viewpoint.

4. **The funding mechanism.** Many buy-sell agreements do not provide a specific funding mechanism, either through insurance, sinking funds, or pre-agreed payment terms. An agreement is no better than the ability of the parties and/or the company to fund any required purchases at the agreed upon price.

5. **Qualifications of appraisers.** Some buy-sell agreements provide a specific list of firms that the parties agree are mutually acceptable, either for a single appraiser option or for the multiple-appraiser options. In other cases, the specific, individual qualifications of appraisers are spelled out (e.g., credentials from a major credentialing organization, experience in appraisal, experience with the industry, etc.).

Credentials can be important. I reviewed a draft buy-sell agreement for an acquaintance a couple of years ago. His company was a $100 million, highly successful service organization. The draft buy-sell stated that the appraiser should be an "accredited general appraiser" in the state of domicile. An accredited general appraiser is qualified to appraise residential or possibly small commercial real estate. This error was fixed in the next draft!
6. **Appraisal standards to be followed.** Some buy-sell agreements go so far as to name the specific business appraisal standards that must be followed by any selected appraisers. For example, I have seen agreements that state that the appraiser(s) must follow the Uniform Standards of Professional Appraisal Practice and the Business Valuation Standards of the American Society of Appraisers.

What’s so hard about specifying these things? I’ve had clients tell me that they have a hard time talking about some of these issues with their fellow shareholders when they are creating their buy-sell agreements. It makes people think about things they don’t want to think about. But think about them you must.

The process of drafting a buy-sell agreement requires the parties to address important issues in balanced form at the outset. In doing so, they are forced to realize that each party could be a buyer - in the event of the death of a partner - or a seller. Actually, if one thinks about being a seller, it is actually his or her estate that will be the seller. This can be tough stuff to deal with.

As I’ve said in numerous speeches, if you think it is difficult to address these issues with your partner(s) in the here and now, just think how difficult it will be when one of you is in the hereafter!

Know this. If these defining elements, including the pricing mechanism, are unclear in your (or your clients’) buy-sell agreement(s), they will be the only thing you will be able to think about following a trigger event until the situation is resolved. Absent a clear agreement, this can take lots of money, lots of time, and create lots of hard feelings. And dealing with the issues under adverse circumstances will absolutely distract you from the business of running your business.

**The Bottom Line**

You probably don't spend much time at night thinking about your (or your clients') buy-sell agreement(s). Take my word for it, you shouldn't. You should be thinking about your buy-sell agreement now, in the light of day, and working to get a clear agreement that works for you and your fellow shareholders or partners.

I never practice law, because to do so requires a license. So I don't have any legal opinions. I prefer to think of them as business opinions.

1. If you are a business owner or shareholder and your buy-sell agreement has not been updated within the last year (or if you don't understand it if it has), run, don't walk, to your corporate attorney to talk through these issues.

If you or your attorneys don't understand the valuation nuances of your buy-sell agreement, don't hesitate to bring in a qualified business appraiser to read the agreement from a valuation perspective and to tell you what he or she thinks it means - or if there is legitimate room for misunderstanding between appraisers. Find out what needs to be done, make the necessary decisions, and fix the document. It will never be easier than right now.

2. If you are a trusted adviser to a business owner or significant shareholder, I would suggest making contact for the explicit purpose of discussing the buy-sell agreement and subjecting it to formal review and/or revision.
3. If you are an executive or director of a large company with multiple joint ventures involving substantial resources, you can bring great value to your company by requesting a review, from legal and valuation viewpoints, of all existing buy-sell and/or put agreements with appraisal-type pricing mechanisms.

Remember this about buy-sell agreements - someone will buy and someone will sell. You just don't know who that will be when you sign the agreement. Your agreement needs to work for you and your family whether you are the buyer or seller. And it needs to work for your partner(s) and their families (or their shareholders) whether they are the buyers or sellers.

This is important. Send this article to any of your friends who own businesses. They will benefit greatly from taking time to review their buy-sell agreements. And send this article to attorneys, accountants, or other advisers of businesses. They can bring great value to their clients by suggesting a review of their buy-sell agreements from legal and valuation viewpoints.

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