The Six Defining Elements of a Process Buy-Sell Agreement

Process agreements, as discussed in the book Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?, are buy-sell agreements involving the use of one or more business appraisers in processes specified for determining value. Mercer Capital professionals have been involved in many valuation processes for determining price (valuations) for buy-sell agreements. In fact, a primary impetus for writing the book was our experiences with problem processes.

If appraisers are to determine price, they need a definition of the assignment. Five elements must be defined in order for the appraiser(s) to provide the type of valuation sought pursuant to the agreement. A sixth element is so important from a business perspective that we include it as an additional defining element.


Let’s begin with the first five defining elements.

1. **Standard of value.** The standard of value is the identification of the type of value being used in a specific engagement. The proper identification of the standard of value is the cornerstone of every valuation. The parties to the agreement may select that standard of value. Will value be based on “fair market value” or “fair value” or some other standard? These words can result in dramatically different interpretations from a valuation perspective. Some agreements simply specify “the value” of the company or interest, which is not adequate to define the standard of value. The likelihood of a successful appraisal process diminishes greatly if the standard of value is not clearly specified.

2. **Level of value.** Will the value 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 play which may cause wide differences in the conclusion of value. Two appraisers could agree on the total value of a business, but if one applies a minority interest or a marketability discount, their conclusions may be significantly different. This is not surprising because their conclusions represent two different levels of value. One appraiser will have valued the business, while the other will have valued an interest in the business. The desired level of value needs to be crystal clear in your agreement.

3. **The “as of” date for the valuation.** Every appraisal is grounded at a point in time. That time, referred to as the “valuation date” or “effective date” or the “as of” date, provides the perspective, whether current or historical, from which the appraisal is prepared. Unfortunately, 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 trigger events establish the valuation date. Because value changes over time, it is essential that the “as of” date be specified.

4. **Qualifications of appraisers.** Some buy-sell agreements provide a list of firms that the parties agree are mutually acceptable. 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.). Unfortunately, many agreements are silent on this issue. Absent clear specification of the appraiser qualifications, there is no assurance that appraisers considered for buy-sell valuations will be qualified to provide the required services.

5. **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 the appraisers. For example, some agreements state that the appraiser(s) must follow the Uniform Standards of Professional Appraisal Practice, the Business Valuation Standards of the American Society of Appraisers, or other standards, as well. These and other valuation standards will be footnoted and discussed in Section Four. Qualified business appraisers will understand the importance of specifying appraisal standards and be familiar with and able to follow relevant standards.

The sixth defining element relates to the funding of buy-sell agreements.

6. **The funding mechanisms.** The funding mechanism is thought of separately from valuation. However, there may be interrelationships between the valuation and the funding mechanism that should be considered in your buy-sell agreement. Funding mechanisms such as life insurance and sinking funds can have a direct impact on value. This aspect aside, the funding mechanism does determine in substantial measure whether the valuation, however developed, can be implemented in future transactions. 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. An agreement that is silent can be like having no agreement at all.

What’s so hard about specifying these defining elements? Getting specific often makes people think about things they don’t want to think about. But think about them they must. 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 are unclear in your (or your clients’) buy-sell agreement(s), following a trigger event they may be the only thing you will be able to think about until the situation is resolved. Absent a clear agreement, this can take lots of money, lots of time, and create lots of hard feelings. In addition, dealing with these issues under adverse circumstances will absolutely distract you from running your business.

*Takeaway Thought:* The assignment definition is critical to the successful outcome of an appraisal process. A failure to define any one of the critical elements could doom the process to an unacceptable outcome.

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. It also needs to work for your partner(s) and their families (or their shareholders) whether they are the buyers or sellers. And it needs to work for the corporation. Your buy-sell agreement won’t meet all these needs by chance alone. You have to make it work. Take action if necessary or appropriate.

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To learn more about buy-sell agreements, attend Mercer Capital’s complimentary webcast, “Buy-Sell Agreements :: How To Know Your Agreement Will Work Without Triggering It.” The webcast will be held Thursday, October 15 from noon - 1:00pm central standard time. For more information or to register, visit www.mercercapitalwebcasts.com.
ANNOUNCEMENT

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Unless you have had your buy-sell agreement reviewed from a valuation perspective, you don’t know what it says. This comes as a surprise to many - an often unpleasant surprise as too many find themselves caught up in unexpected and costly legal wrangles or personal turmoil. This complimentary webcast provides you with information from a valuation perspective that will help ensure that your buy-sell, shareholder, or joint venture agreement results in a reasonable resolution and is not a ticking time bomb set to explode upon a triggering event. You will leave this webcast knowing what to do to eliminate future surprises with your buy-sell agreement.

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January 2007
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