



# Buy-Sell Agreements – Defusing the Ticking Time-Bomb

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# Disclaimers

- No information contained in this webinar should be interpreted as legal advice. Useful legal advice generally costs money and is best received from an attorney
- Each business's and shareholder's set of circumstances is unique. Apply any of the information contained in this webinar entirely at your own risk
- Seek professional guidance before undertaking critical business decisions.




# Bottom Line Up Top

- Many buy-sell agreements are bound to self-destruct
- Recommended mechanism is to engage a single appraiser
- Objectives of the buy-sell conditions should set parameters of the appraisal process
- The terms of sale are as important as the price
- Buy-sell agreement structures have important tax implications



# Starting Point

- A buy-sell agreement is an agreement in which a process is agreed in advance by which a shareholder's equity interest will be purchased, contingent upon the occurrence of one or more future events
- We use "shareholders" as a term referring to any equity owner, even though it is technically incorrect for certain equity structures



# What Most Buy-Sells Really Are...

- A game of financial chicken
- A financial “dead pool”
- A bet between and among the shareholders regarding who needs to be bought out first
- A bet on the company, the economy, and the market



# Who Should Have a Buy-Sell Agreement?

- Any company in which the shareholders place importance on the value of their holding
- Even more important when shareholders are also friends/family
- Shareholders who are not married
- An alternative succession plan is not in place
- Some relatively illiquid public companies



# Objectives of the Buy-Sell

- Allow for orderly exit of shareholders *without selling equity interests to outsiders*
- Protect the company from being damaged by adverse circumstances arising for one shareholder
- Limit risk of litigation
- Avoid chaos in the process of exiting a shareholder
- Encourage/discourage certain behaviors



# How Buy-Sell Agreements Operate

- Buy-sell agreements are like nuclear bombs – you hope they are never used
- Typically, the buy-sell agreement, is written early in the company’s life and forgotten
- A “trigger event” specified in the buy-sell agreement sets the buy-sell process in motion
- The buy-sell is executed, one way or another (often, another)



# Why Buy-Sell Agreements Fail

- The triggers for the buy-sell are usually unpleasant for at least one party
- The buy-sell price is a surprise (especially to the party it doesn't benefit)
- The price is not credible and is inconsistent with current observable facts
- One side believes the other has manipulated the buy-sell process to their benefit
- The terms of the buy-sell are impractical, even at a fair price
- The buy-sell agreement is poorly-conceived and/or written



# So What if the Other Guy Doesn't Like the Buy-Sell?

- The Other Guy can make life unpleasant and expensive
- The Other Guy (or his estate) may challenge the validity of the agreement
- Loopholes in the agreement can be exploited to suspend execution
- Even good buy-sells take months to execute
- Hard to make distributions
- Friendships are destroyed, families torn apart


# Typical Triggers of Buy-Sell Agreements

## Unhappy Triggers

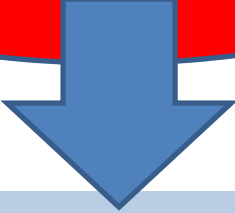
- Shareholder dies
- Shareholder is disabled
- Shareholder is fired
- Shareholder divorces
- Shareholder files for bankruptcy
- Shareholder defaults on collateralized financial obligation

## Happy Triggers

- Retirement of shareholder



Most buy-sell agreements are triggered by events that are causes of tension and duress on the part of selling shareholder.



Misunderstandings and arguments are more likely to arise. One or both parties more likely to behave irrationally.



## Other Triggers Not as Often Considered

- Shareholder is indicted or convicted of a crime (especially felony)
- Shareholder loses a key license or accreditation
- Shareholder is censured by a key industry governing or accrediting body
- Shareholder loses residency status
- Shareholder unable to meet a capital call



# Types of Buy-Sell Agreements

- Fixed Price
  - One shareholder buys the other out at a price set in the agreement
- Fixed Formula
  - One shareholder buys the other out at a price determined by a formula contained in the agreement
- Appraiser-driven
  - Some combination of up to three appraisers determines the price at which the buy-sell will be executed



# Summary of Fixed Price Agreements

## Advantages

- Easy to understand
- Easy to execute
- Low-cost to put in place

## Drawbacks

- At most, the price is right once – less often than a broken clock
- Unless an appraiser helped set the price, it was probably never right to begin with
- That price was valid for perhaps 6-12 months at most

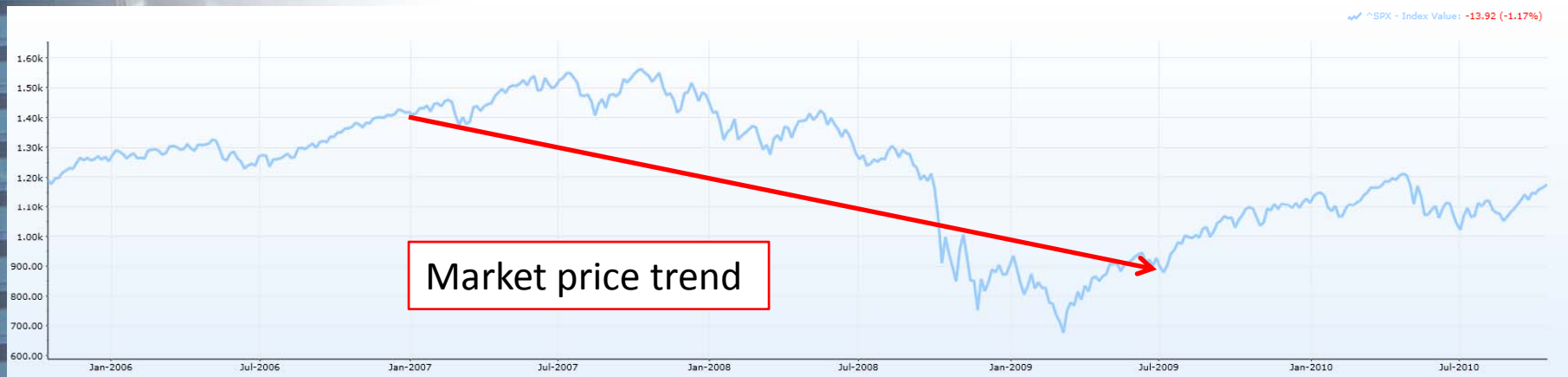


# Example of Fixed Price Agreement

- Example: a buy-sell agreement indicates that if the buy-sell is triggered, the equity value of the business will be priced at \$1,000,000.
- Circumstances trigger the sale by the 40% shareholder to the 60% shareholder
- The buy-sell agreement was made Jan 1, 2007
- Revenues and profits have been flat since the buy-sell was agreed

# The Fixed-Price Buy-Sell is Triggered on July 1, 2009...

Buyer must pay the seller (departing shareholder) \$400,000 for his share. Is this a fair deal?



Based on general market movements, the company may not be worth \$1MM anymore. Seller/departing shareholder has an incentive to manipulate a buy-sell trigger.



# Summary of Formula Agreements

## Advantages

- Can be written so as to be understand
- Easy to execute
- Inexpensive to execute
- Low-cost to put in place

## Drawbacks

- The price may be right more often than a fixed price – but still much less often than a broken clock
- Formulas are often set by way of folk wisdom
- No formula worth using can capture every source of (and drag on) value

# Example of Formula Agreement

- Example: a buy-sell agreement indicates that if the buy-sell is triggered, the equity value of the business will be priced at 5.0x trailing twelve months' EBITDA.
- Circumstances trigger the sale by the 40% shareholder to the 60% shareholder
- The buy-sell agreement was made Jan 1, 2007
- EBITDA was \$250,000 for the trailing twelve months through September 30, 2010
- EBITDA was \$250,000 so price is  $5.0 \times \$250K = \$1,250,000$ . Price of 40% share is \$500,000.



# The Formula Buy-Sell Agreement is Triggered on September 30, 2010

- Per buy-sell formula, the price of the company is \$1,250,000. Price of 40% share is \$500,000.
- Now consider:
  - The company was on the verge of signing a new customer which will result in doubling the company's revenue next year
  - The company holds \$400,000 in excess cash and marketable securities
  - The company owns \$100,000 in real estate

*That \$500,000 price is a real bargain for the buyer!*



# Summary of Appraiser-Driven Agreements

## Advantages

- Value(s) will reflect **current** status of company, market and economic environment
- Arbitrary nature of value is eliminated
- When the process works, the value result is credible
- Opportunity for manipulation is curtailed

## Drawbacks

- Time-consuming
- Competent appraisals are expensive
- Require more up-front thought and discussion
- Even appraisal-driven processes can be problematic



## Example of Appraiser-Driven Agreement

- Example: a buy-sell agreement indicates that if the buy-sell is triggered, the company and the departing shareholder will commission their own appraisals. If they are relatively “close”, the average of the two values will be used. If they are not “close”, the two appraisers will select a third appraiser to perform yet another appraisal, and that value shall be the final buy-sell price.

# The Two Appraisers Fail to Agree

- The appraiser engaged by the company values the company at \$1,000,000 (40% interest = \$250,000, including minority interest discount)
- The appraiser engaged by the departing shareholder values the company at \$1,500,000 (40% interest = \$600,000).
- The appraisers, with input from their clients and their respective legal counsel, struggle to identify a third appraiser and set the parameters for such an appraisal – the process drags on for months. As discussions and correspondence become less civil, litigation appears inevitable.



# How Can Appraisers Fail to Agree?

- Differing standards of value (fair market value, fair value, investment value)
- Differing bases of value (marketable/non-marketable; controlling/non-controlling)
- Differing sources of information and methodologies
- Difference in informed appraiser judgment
- Client manipulation



# Solution: Use One Appraiser

- Limits process to one round of appraisals
- Eliminates “my appraiser” vs. “your appraiser” arguments
- Limits scope of potential conflict
- Value determined by a professional subject matter expert
- Buy-sell price will be connected to current value characteristics of the company



# Appraiser Guidance within the Buy-Sell

- Set parameters of value
- Require that work product be produced in conformance with professional valuation standards (e.g. USPAP, SSVS-1, other)
- Require that work product be produced in writing and in non-abridged format
- Appraiser must be free to select methods and approaches he deems will lead to the most credible value conclusion
- The appraiser's job is to determine value only.  
Not mediate, not negotiate, not advocate

# Standard of Value

Standard of Value	Comment
Fair Market Value	Typically used for tax compliance and certain other compliance purposes. Tends to produce lower value (favors buyer). Excludes synergistic value.
Fair Value	Fair value has no universal statutory definition. Most definitions ignore discounts typically considered under fair market value. Minority positions simply valued pro rata per company (equity or enterprise) value. Tends to produce a higher value and favor the seller.
Investment Value	Value from the perspective of a (hypothetical) financial investor with a particular return requirement.
Market Value	Standard typically applied to real estate. Often leads to highest value result. Allows incorporation of synergistic effects. Value standard that is implicitly used by investment bankers (even if they don't use that term).

You may call for a calculated adjustment to the value result based on a particular standard.



# Which Standard to Select?

- Choose *fair market value* if you want most universally accepted definition of value, and you want buy-sell to favor the company
- Choose *fair value* if you want to avoid penalizing a departing shareholder
- Choose *investment value* if you want to replicate a hypothetical insider transaction
- Choose *market value* if you want to replicate a sale of the business to a motivated third-party buyer

# Bases of Value

Basis of Value	Comment
Marketable/non-marketable	<ul style="list-style-type: none"><li>• How easy is it to sell the business or business interest?</li><li>• Is there a ready market?</li><li>• Are there legal barriers to sale?</li><li>• Right of first refusal?</li><li>• Personal goodwill?</li><li>• Incorporates discount for lack of liquidity</li></ul>
Controlling/non-controlling	<ul style="list-style-type: none"><li>• Who can force a sale of the business?</li><li>• Who decides where the cash goes?</li></ul>

Generally, the basis of value applies to fair market value only, but a buy-sell can specify that the basis of value applies to a different standard.

# Premises of Value

Premise of Value	Comment
Going concern	<ul style="list-style-type: none"><li>• Is forward-looking</li><li>• What are the business' prospects for future profitability?</li></ul>
Liquidation value	<ul style="list-style-type: none"><li>• The business will cease operations as an independent entity</li><li>• Assumes an orderly sales process (not a fire sale)</li><li>• Typically, appropriate for holding companies and/or companies in severe financial distress</li></ul>

Selecting the premise of value may depend upon the company's realistic prospects for continued operation after the execution of the buy-sell agreement



# Other Considerations

- Effective date of appraisal (usually trigger date but not always)
- How are life insurance policies/sinking funds treated?
  - Not an asset of the company but rather an offset to the anticipated liability for completing the buy-sell agreement
- How are built-in gains for C-corporations treated?
  - Tax liability



# The Law of One Price?

- The terms and price of buy-sell may vary depending on circumstances of shareholder departure
  - If you're firing him for cause do you want to reward him on the way out?
- May also vary depending on characteristics of shareholder
  - One shareholder's contribution was mostly cash while the other's was sweat equity
- May vary depending on time elapsed
  - Consider a discount built in to "appraised value" if service tenure with company is relatively brief
- Consideration of key person impacts



# Meeting the “Buy” Part

- The buy-sell agreement should discuss how the purchase will be funded
  - Insurance (life, disability)
  - Note (2-10 years)
  - Sinking fund
  - Funded trust
- Without these features or something similar, financial burden of purchase may place company in financial distress or even force liquidation
- Identify who is actually buying the shares – a shareholder or the company



# Other Important Buy-Sell Terms

- Non-competition agreements
- Non-solicitation agreements
- Non-disparagement agreements
- Confidentiality agreements
- Transition services
- Assignment of intellectual property rights
- Assignment of loan guarantees
- Continuing rights of departing shareholder prior to settlement date
- Disposition of shareholder loans

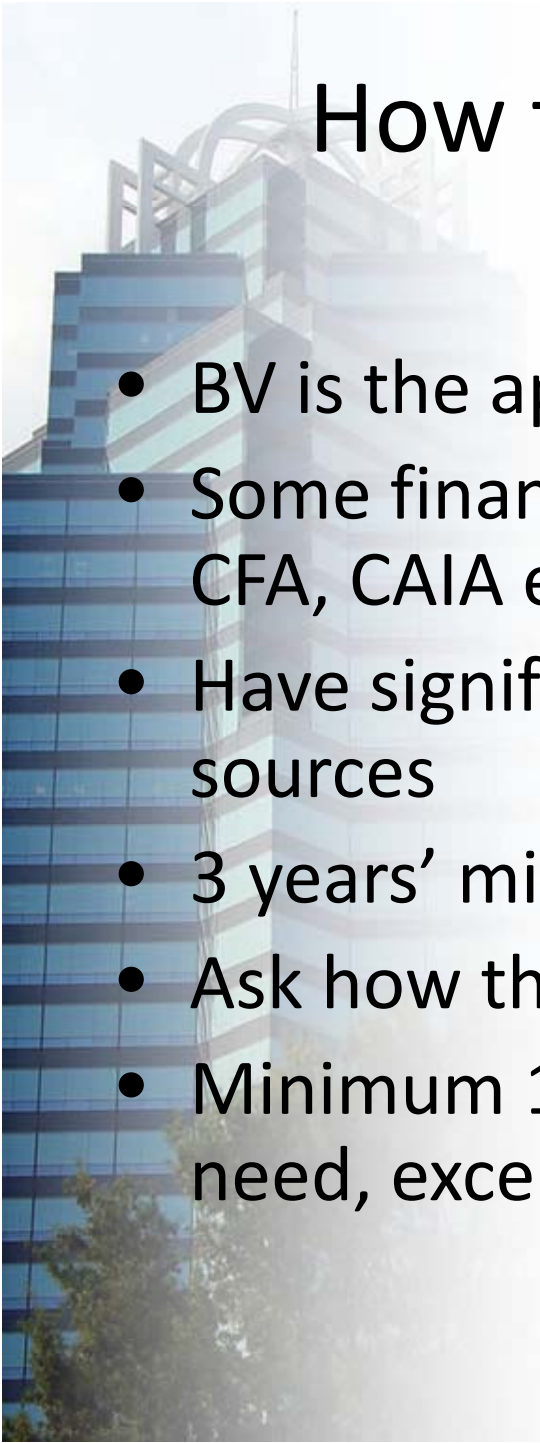


# How to Engage an Appraiser for a Buy-Sell Agreement

- At the outset identify a list of firms, in order of preference, to perform the appraisal, and include the identities of firms in the buy-sell agreement
- Specify the qualifications of the individual who will perform the actual appraisal (education, location, professional accreditations, experience)
- Perform an appraisal upon signature of buy-sell agreement
- Update appraisal annually, preferably by same firm
- Budget 4-6 months to complete entire process
- After triggering of buy-sell, the appraiser used may not provide services to either side for 2 years

# Alphabet Soup (Accreditations)

<b>Designation</b>	<b>Accrediting Organization</b>	<b>Requirements</b>
Accredited Senior Appraiser (ASA)	American Society of Appraisers	96 hours of BV coursework 15 hours of professional standards coursework 6 exams 1 peer-reviewed report 5 years of BV experience
Certified Valuation Analyst (CVA)	National Association of Certified Valuation Analysts	Holds CPA 40 hours of coursework 1 peer-reviewed report or case study exam
Certified Business Appraiser (CBA)	Institute of Business Appraisers	90 hours of coursework or 5 years of experience in BV 2 peer-reviewed reports*
Accredited in Business Valuation (ABV)	American Institute of Certified Public Accountants	Holds CPA 45 hours of coursework



# How to Assess an Appraiser or Appraisal Firm

- BV is the appraiser's full-time job
- Some financial accreditation (ASA, ABV, CVA, CFA, CAIA etc.) beyond CPA
- Have significant investment in research/data sources
- 3 years' minimum experience
- Ask how they resolve conflicts
- Minimum 10 appraisals a year (of the type you need, except litigation)

# How to Read the Valuation Report

Key Point	Explanation
Which approach to valuation was employed?	Do you understand the methodology? Do you understand why other methodologies were considered but not used?
What professional standards apply?	To which set of standards is the appraiser accountable?
Do you understand the sources of information used?	Are there any sources that should have been used but were not? Are they unbiased?
Did the appraiser perform a site visit?	Would an appraiser learn important information from a physical inspection?
Is fact from judgment clearly defined in the report?	Appraiser judgment is unavoidable in business valuation. Are facts available that might lessen the reliance upon assumptions?
Is each piece of information connected to the value result?	Is genuine analysis apparent throughout the report or do large sections appear to be “boiler plate”?
Appraisal credibility	Does the appraisal narrative make logical sense?



Thank you for your  
attention.

*Questions?*