Part I

Your Buy-Sell Agreement

Ticking Time Bomb or Reasonable Resolution?

Buy-sell agreements are some of the least understood, yet most important corporate documents in your client's corporate files. Nearly every business of any size with more than one shareholder has – or should have – a buy-sell agreement. These agreements establish the mechanism for the purchase (and corresponding sale) of equity interests upon the occurrence of certain "trigger events." Trigger events can be remembered by an acronym, QFRDD:

- **Q**uits
- **F**ired
- **R**etires
- **D**isabled
- **D**ies

If you think about it, these events are called "trigger events" because someone almost certainly has a gun to his or her head, whether your company or a shareholder when they happen.

Buy-sell agreements come in three types: cross-purchase agreements, entity-purchase agreements, and hybrid agreements. Cross-purchase agreements call for individual shareholders to carry life insurance on the lives of other shareholders. This may not be economical (if a company has substantial economic value) or workable (if there are many shareholders).

Entity-purchase agreements call for a company to purchase shares when a shareholder leaves as result of any of the trigger events.

Hybrid agreements provide for the company to pass purchase rights to shareholders under certain circumstances. Most buy-sell agreements that we see in our practice are entity-purchase agreements.

There are really four ways an agreement can determine value when trigger events happen.

- *Fixed price.* The shareholders can agree on a fixed price. The only problem is that, if your client is like most businesses, they will never update the agreement and the value mechanism will become woefully out-of-date.

- *Formula.* The shareholders can agree on a formula. The only problem is that there is no formula that will provide reasonable results over time given the changing nature of the markets, the industry, and the company.

- *Shotgun.* Sounds fair, because if you name the price, I get to decide whether I'll buy or sell. The only problem is that this doesn't work with more than two shareholders, and it may not work if someone's spouse has that shotgun placed at his or her head.

- *Appraisal process.* Many buy-sell agreements provide for a business appraisal process to determine value when trigger events occur. There are multiple appraiser processes and single appraiser processes.

Some owners think that they have a pricing mechanism with a *right of first refusal*. The only problem is that there is no requirement to either buy or to sell. Therefore, there is no assurance of a transaction when trigger events occur. Rights of first refusal are often used in conjunction with buy-sell agreements in order to ensure that remaining shareholders get to choose who they will be in business with.

All the pricing mechanisms other than appraisal processes have a common characteristic. The parties to the agreements are betting that the other party (or parties) will die, or retire, or otherwise leave first. One of them will be right; however, that will not likely be good for the other, if the price is unreasonably set by an out-of-date fixed price, a faulty formula, or otherwise.

So let us examine business appraisal processes. Many agreements call for one side to retain one business appraiser and for the other side to retain another. Usually, both appraisers provide valuations. If they are within 10% or so of each other, the average is the concluded price and the process is over. If not, the first two business appraisers generally select a third business appraiser, whose job it is to reconcile the disparities. The third appraiser's conclusion will either be averaged with one or both of the first two conclusions, or it may even be determinative of value.

The bottom line is that you and your client will not know, until a trigger event occurs, how this process will play out – nor will you or your client have any idea what the value will be. That's not good business.

We have recommended a single appraiser process for companies for many years. All parties to a buy-sell agreement agree on a single appraiser at the time the agreement is signed. The appraiser then provides an appraisal based on the kind of value agreed upon. If there are any problems with the definitions of value or other aspects of the process, they will be uncovered and can be fixed. The appraisal becomes the initial value for purposes of the agreement.

The selected business appraiser then provides a reappraisal every year (or two for smaller companies) to update the buy-sell price. The parties then have current valuation information for personal and corporate planning purposes. The appraiser may have to provide an appraisal following a trigger event, depending on how long it has been since the last appraisal. Everyone knows what will happen and is knowledgeable about value and the process all along. That's good business.

To find out why the time and expense of working on the buy-sell agreement and providing for a regular appraisal is cost-effective, even for not-so-large businesses, see Part 2 of this series in a future issue.

Z. Christopher Mercer, ASA, CFA, ABAR is the CEO and founder of Mercer Capital, a national business valuation and investment banking firm. He is also the author of *Buy-Sell Agreements for Closely Held and Family Business Owners: How to Know Your Agreement Will Work Without Triggering It.* He can be reached at 901.685.2120 or mercerc@mercercapital.com.