

How to Know Your Agreement Will Work  
Without Triggering It



# BUY-SELL AGREEMENTS

for Closely Held and Family Business Owners

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# Pete and Sam



**Pete:** “**Sam, I just buried a small bomb in your yard. It isn’t large enough to kill you, your wife, or another member of your family, but it would certainly maim you or them if one of you stepped on it.**”

Sam: “Where is it?”

**Pete:** “**I’m not going to tell you where it is. But don’t worry. Chances are it is so well-hidden that no one will ever step on it.**”

Sam: “What do you mean, ‘chances are’? That’s a chance I can’t take! If it were just me it would be one thing, but you’re talking about hurting my wife and family!”

**Pete:** “**Like I said, don’t worry. Maybe no one will ever step on it. Maybe it will never explode.**”

Sam: “You must be crazy! I’ll bring in a bomb squad and dig up the entire yard to get rid of that it!”

**Pete:** “**Now Sam, you know I’m just kidding about the bomb. However, your buy-sell agreement might very well be a ticking time bomb and you just don’t know it. How about taking some time to talk about your buy-sell agreement – say, dinner tomorrow night?**”

Sam: “Sounds good to me. See you then.”



# What Is a Buy-Sell Agreement?



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 that 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



Require agreement **at a point in time**

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Relate to transactions that will or may occur  
**at future points in time**

---

Define the conditions that  
**“trigger”** the buy-sell provisions

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Determine the **price(s)** at which the  
specified future transactions will occur

# Potential “Trigger Events”



- » **Q** Quits
- » **F** is Fired
- » **R** Retires
- » **D** Disabled
- » **D** Death
- » **D** Divorce
- » **B** Bankruptcy
- » Others?



# The 20 Ds



- » Departure
- » Discharge
- » Death
- » Divorce
- » Disability
- » Default
- » Disqualification
- » Disaffection
- » Disagreement
- » Disclosure
- » Dispute resolution
- » Dilution
- » Dividends
- » Distributions
- » Drag-along rights
- » Double entities
- » Differential pricing
- » "Don't compete" agreements
- » Donate
- » Distributions after a trigger event

# Three Questions to Ask Yourself



1

**Do you have a buy-sell agreement?**

If so, what type of agreement is it?

2

**Do you know what your buy-sell agreement says?**

There are six defining elements that must be in every process agreement if you want the valuation process and, therefore, the agreement, to work

3

**How is your buy-sell agreement funded?**

How life insurance proceeds are treated can make a big difference in the valuation of the company



1

# Do You Have a Buy-Sell Agreement?



**Every successful company with  
two or more owners has a  
buy-sell agreement – or should!**

# How Do Buy-Sell Agreements Come Into Existence?



## POTENTIAL OPPOSING SHAREHOLDER CHARACTERISTICS THAT MAKE DISCUSSING BUY-SELL AGREEMENTS DIFFICULT

Characteristic	Shareholder 1	Shareholder 2
Age	Younger	Older
Ownership	Noncontrolling	Controlling
Involvement	Active	Inactive
Personal Outlook	Optimistic	Pessimistic
Investment Type	Sweat Equity	Real Money
Investment Amount	Smaller	Larger to Much Larger
Personal Guaranties	None	Substantial

**Get Agreement. Now.**



**Just Do It.**

# Types of Buy-Sell Agreements



Based on how price is determined

- Fixed-price agreements
- Formula agreements
- Shotgun agreements
- **Process agreements**



# 1. Fixed-Price Agreements



## DESCRIPTION

- » You and the other owner(s) agreed on a price.
- » That price of your agreement is likely years out of date.
- » There are three possibilities regarding the price you set:
  - The value today is lower, perhaps far lower, than the realistic value.
  - The value today is higher, perhaps far higher, than the realistic value.
  - The value is the same as it was back then.

*You haven't agreed on a way to update the price.*

## REALITIES SELDOM DISCUSSED

- » If the value is unrealistically low, you are betting that the other guy will die first and you'll get to buy at the low price.
- » If the value is unrealistically high, you are betting that you'll be the one to leave the business so you and your family can benefit.
- » The other guy(s) are making just the opposite bets.

*Why take a chance that you'll be on the wrong end of that bet?*

# 1. Fixed-Price Agreements



## ADVANTAGES

- Easy to understand, easy to negotiate – the first time only!
- Inexpensive
  - › Easy for attorneys to draft
  - › No appraisers required

## DISADVANTAGES

- Fixed prices are seldom updated, even over periods of many years. Inequities are almost certainly a result of out-of-date fixed price agreements
- Easy to set an initial price, but may be difficult to reset as time passes and interests diverge
- The longer period of time between updates to fixed price agreements, the greater the potential for a divergence of the interests of the various parties
- The normal “fix” to this problem is a flawed process agreement
- **Betting that the other guy(s) will die first!**

# 2. Formula Agreements



## DESCRIPTION

- » You and the other owner(s) established a formula to calculate price.
- » Chances are, no one has calculated it lately.
- » Chances are, it can give an unreasonable result now.
- » Combined with changes in the company and the industry:
  - The formula price may be higher than a realistic value today.
  - The formula price may be lower than a realistic value today.
  - The formula price is realistic today.

*You haven't agreed on ways to make necessary/appropriate adjustments.*

## REALITIES SELDOM DISCUSSED

- » If the value is unrealistically low, you are betting that the other guy will die first and you'll get to buy at the low price.
- » If the value is unrealistically high, you are betting that you'll be the one to leave the business so you and your family can benefit.
- » The other guy(s) are making just the opposite bets.

*Why take a chance that you'll be on the wrong end of that bet?*

# 2. Formula Agreements



State a single formula to be applied to balance sheet and/or income statement metrics

## EXAMPLES

- Multiple of EBITDA – (5 x EBITDA)
  - » Less debt?
- Book Value
  - » “Shareholders’ equity per the audited financial statements at the end of the fiscal year immediately preceding the valuation date.”

# 3. Shotgun Agreements



- » Concept is that the initial offering side (which will that be?) virtually has to name a “reasonable” price, i.e., one at which he would be willing to buy or sell
- » Assumes both parties have equal financial capacities and knowledge about the business and its prospects to engage in either a buy or a sell transaction

# 4. Process Buy-Sell Agreements



## DESCRIPTION

- » You and the other owners agreed to let business appraisers set the price for your agreement if and when it is triggered.
- » No one has the foggiest idea what will happen or what the price will be.
- » No one knows what “kind of value” the appraiser will provide:
  - It could be the value of an illiquid interest.
  - It could be the value of the entire enterprise pro rata to ownership.
  - It could be reasonable and what you thought you agreed to.
  - It might not be reasonable and what you thought you agreed to.

*No one will know until the end of a lengthy and uncertain process what the outcome will be.*

## REALITIES SELDOM DISCUSSED

- » You are betting that the ultimate price will be favorable (or at least reasonable) for you.
- » The other owners are betting that the ultimate price will be favorable (or at least reasonable) for them.
- » The company is betting that the process will work and that the price set will be affordable.

*Everyone is betting and someone will lose.*

# 4. Process Buy-Sell Agreements



- » A buy-sell agreement provides a valuation process employing one or more appraisers
- » Value is determined by the appraisers in a manner defined in the buy-sell agreement
- » Two types of process buy-sell agreements:

MULTIPLE APPRAISER

SINGLE APPRAISER

# 4. Process Buy-Sell Agreements



» Your (client's) buy-sell agreement should be

**UNDERSTANDABLE**

**PREDICTABLE**

**LIKELY TO ACHIEVE  
REASONABLE RESOLUTIONS**

**HELPFUL IN THE WEALTH  
MANAGEMENT PROCESS**

# 4. Process Buy-Sell Agreements



## » Recommendation

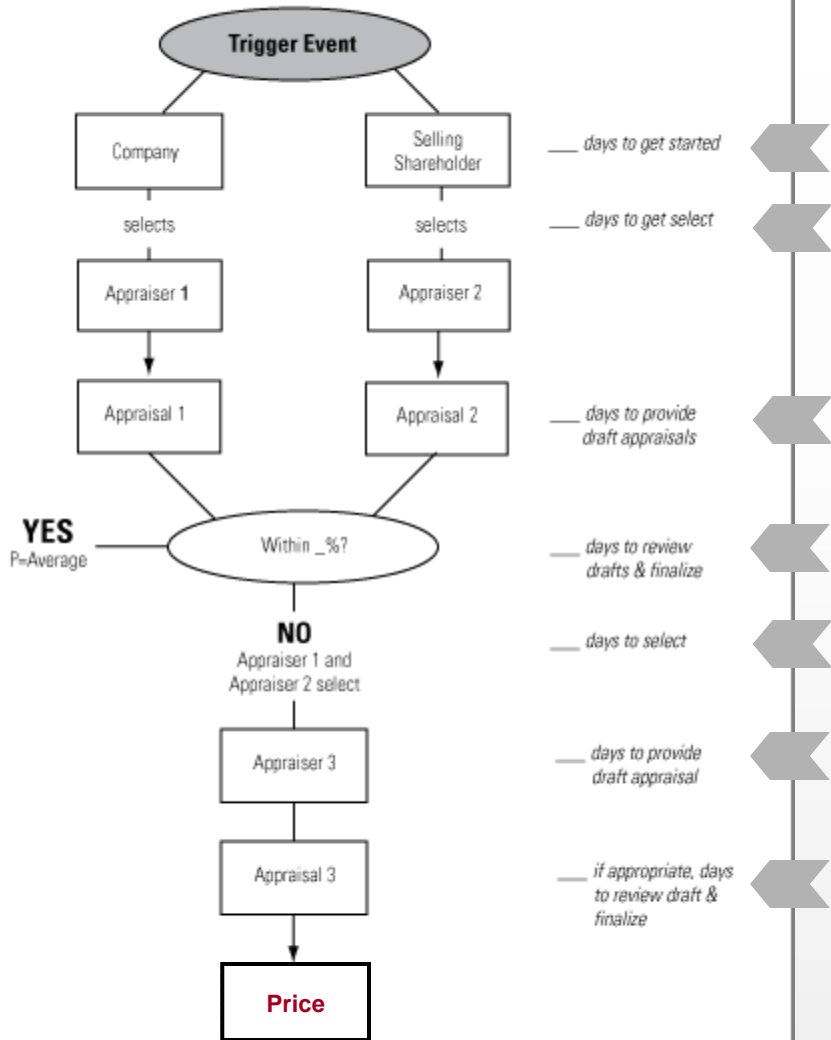


» Good for clients' businesses

» Excuses, excuses, excuses...No excuses, really



### MULTIPLE APPRAISER PROCESS AGREEMENT



# Multiple Appraiser Agreements

#### Appraiser 3 is the Tie-Breaker

- × Average with other two [gives credence to outliers]
- × Average with the closer of Appraisal 1 and Appraisal 2
- × The conclusions of Appraisal 1 and Appraisal 2 may establish upper and lower bounds for final price

# 4. Process Buy-Sell Agreements



DISADVANTAGES		MULTIPLE APPRAISERS
1.	Price not determined now	x
2.	Potential for dissatisfaction with the process for all parties	x
3.	Danger of advocacy	x
4.	Uncertainty over what will happen when a trigger event occurs	x
5.	Uncertainty over final price if the process is invoked	x
6.	Problems or issues with definition of value, qualifications of appraisers, or any other aspects of the operation of the agreements are deferred until a trigger event – when the interests of the parties are adverse	x
7.	Expensive	x
8.	Time-consuming	x
9.	Distracting for management	x
10.	Potentially devastating for affected shareholders and their families	x





## **Key Recommendation**

Single Appraiser,  
Select Now and Value Now

# Single Appraiser, Select Now and Value Now



## SELECT NOW

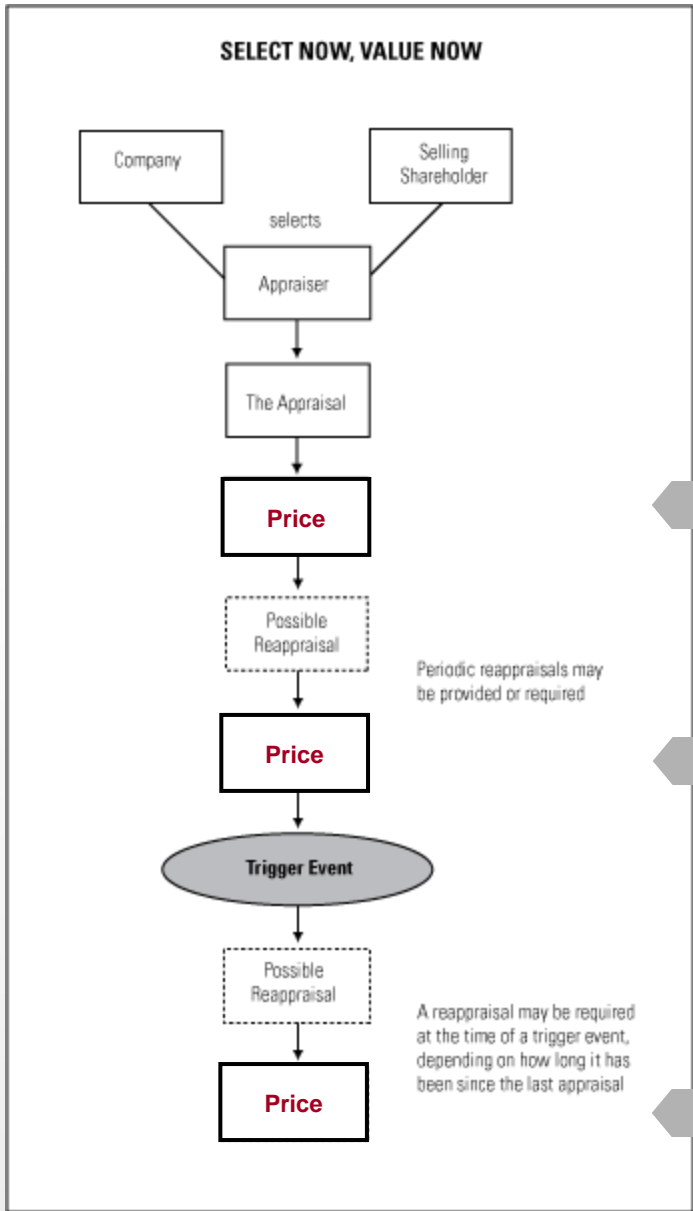
- » I have long recommended that parties creating buy-sell agreements name the appraiser at the time of agreement. This way, all parties have a voice and can sign off on the selection of the appraiser no matter how difficult the process of reaching agreement.

## VALUE NOW

- » Once selected, the chosen appraiser provides a baseline appraisal for purposes of the agreement. I suggest that the appraisal be rendered in draft form to all parties to the agreement, and that everyone has a reasonable period of time to provide comments for consideration before the report is finalized.

## VALUE EACH YEAR (OR TWO) THEREAFTER

- » Ideally, the selected appraiser will provide annual revaluations for buy-sell agreement purposes.



## RECOMMENDATION

# Single Appraiser Agreement

## Select Now, Value Now

# Single Appraiser Agreement

## *Select Now, Value Now*



### ADVANTAGES

- Selected appraiser viewed as independent
- Appraiser's valuation process is seen by all parties at the outset
- Appraiser's conclusion is known at outset and has established a baseline price for the agreement
- Because process is observed at the outset, all parties know what will happen when trigger event occurs
- Because the appraiser must interpret the "words on the pages" in conducting the initial appraisal, any issues regarding lack of clarity of valuation-defining terms will be resolved
- Selected appraiser must maintain independence with respect to process and render future valuations consistent with terms of agreement and with prior reports

# Single Appraiser Agreement

## *Select Now, Value Now*



### ADVANTAGES (CONTINUED)

- Subsequent appraisals, either annually or at trigger events, should be less time-consuming and expensive than other alternatives
- Parties should gain confidence in the process
- Parties will always know the current value for the buy-sell agreement (helpful for planning all-around)
- Appraisers' knowledge of the company and its industry will grow over time, enhancing confidence for all parties with the process
- Creates a means of maintaining pricing for other transactions, thereby enhancing "the market" for a company's shares

# Multiple Appraiser vs. Single Appraiser, Select Now and Value Now



DISADVANTAGES		MULTIPLE APPRAISER	SINGLE APPRAISER Select Now and Value Now
1.	Price not determined now	x	
2.	Potential for dissatisfaction with the process for all parties	x	Minimized
3.	Danger of advocacy	x	Minimized
4.	Uncertainty over what will happen when a trigger event occurs	x	Minimized
5.	Uncertainty over final price if the process is invoked	x	Minimized
6.	Problems or issues with definition of value, qualifications of appraisers, or any other aspects of the operation of the agreements are deferred until a trigger event – when the interests of the parties are adverse	x	Minimized
7.	Expensive	x	
8.	Time-consuming	x	
9.	Distracting for management	x	
10.	Potentially devastating for affected shareholders and their families	x	



# 2

## **Do You Know What Your Buy-Sell Agreement Says?**

# Do You Know What Your Buy-Sell Agreement Says?



## » From a **business perspective?**

- » Departure
- » Discharge
- » Death
- » Divorce
- » Disability
- » Default
- » Disqualification
- » Disaffection
- » Disagreement
- » Disclosure
- » Dispute resolution
- » Dilution
- » Dividends
- » Distributions
- » Drag-along rights
- » Double entities
- » Differential pricing
- » "Don't compete" agreements
- » Donate
- » Distributions after a trigger event

## » From a **valuation perspective?**

# The Six Defining Elements of Process Buy-Sell Agreements



Standard of Value

Qualifications of Appraisers

Level of Value

Appraisal Standards

The “As Of” Date

Funding Mechanism

# Defining Element #1

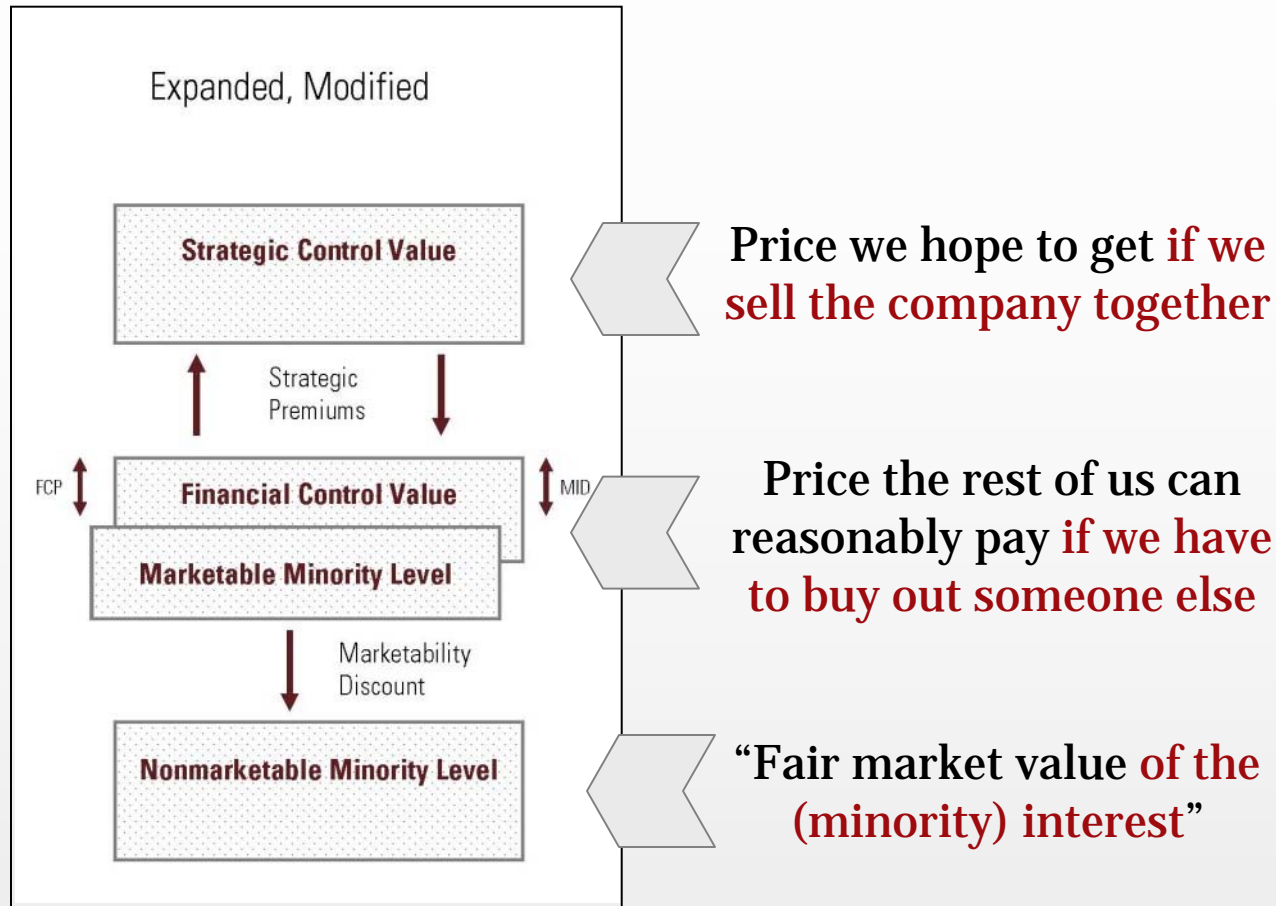
## Standard of Value



- » Normally fair market value
  - Willing buyer, willing seller....but buyers of what?
- » Fair value
  - Defined under state law
  - A defined term, of sorts, under accounting rules
- » Investment value
  - From the perspective of whom?
- » “The Value,” “Going Concern Value,” and on and on and on...

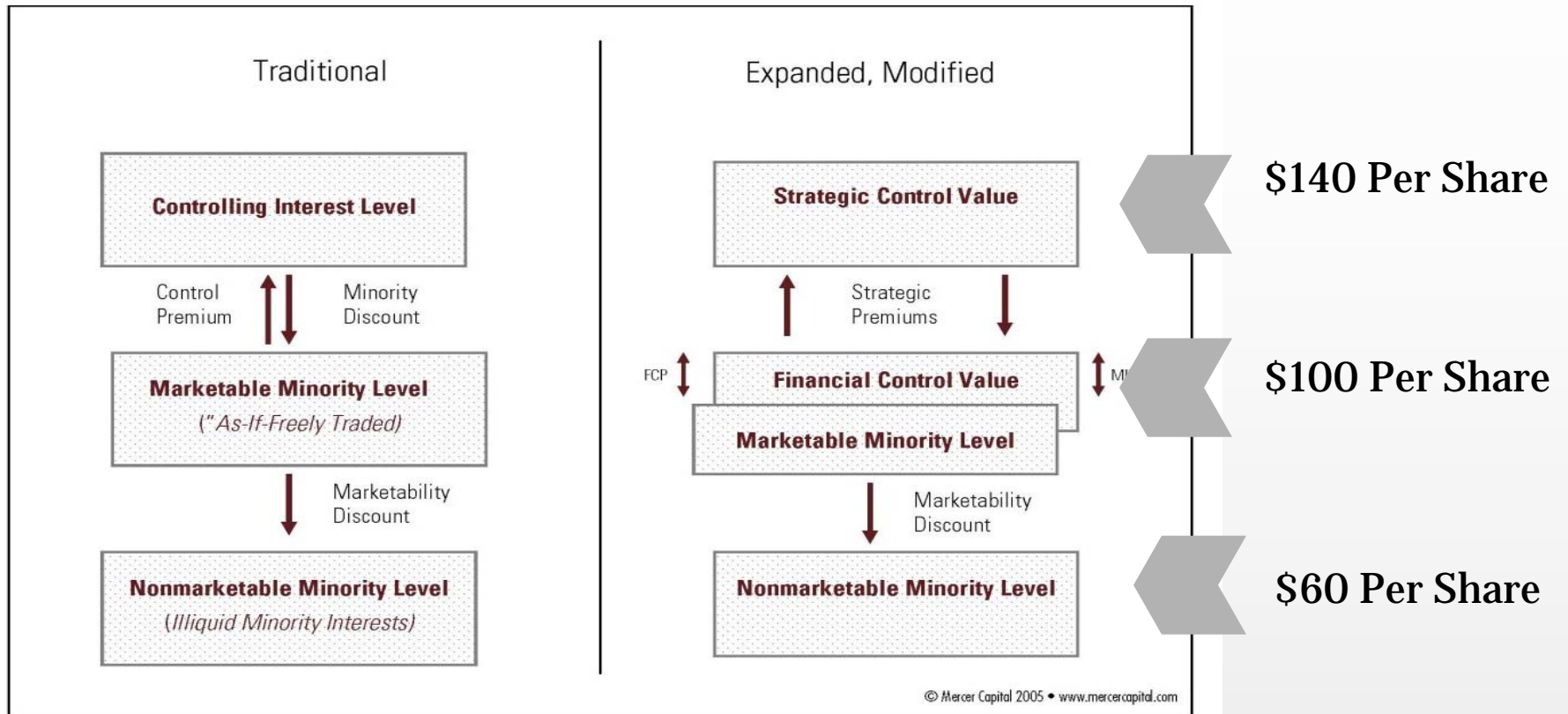
# Defining Element #2

## Level of Value



# Defining Element #2

## Level of Value



# Defining Element #3

## The “As Of Date”



» There is no such thing as “The Value”

- Value is “as of” a specific point in time
- Is based on information known or reasonably knowable

# Defining Element #4

## Qualifications of Appraisers



### INDIVIDUAL

- »Education
- »Valuation training
- »Appraisal experience
- »Industry experience
- »Continuing education
- »Publishing
- »Credentials

### FIRM

- »Size
- »Longevity
- »Specialization

# Defining Element #5

## Appraisal Standards



- » Uniform Standards of Professional Appraisal Practice (USPAP)
- » ASA Business Valuation Standards
  - Principles of Appraisal Practice and Code of Ethics
- » AICPA Statement on Standards for Valuation Services (SSVS) No. 1
- » Institute of Business Appraisers Business Valuation Standards and Rules of Professional Conduct.
- » NACVA Professional Standards
- » CFA Institute Code of Ethics & Standards of Professional Conduct

# The Six Defining Elements of Process Buy-Sell Agreements



Standard of Value

Qualifications of Appraisers

Level of Value

Appraisal Standards

The “As Of” Date

**Funding Mechanism**



# 3

## How is your Buy-Sell Agreement Funded?

# How Is Your Buy-Sell Agreement Funded?



The company will issue a promissory note...

## BUYER-SELLER TENSIONS

	Buyer (Company)	Seller (Shareholder)
Price	Low	High
Terms	<b>Lenient</b> <i>Long Term</i> <i>Deferred Payments</i> <i>Low Interest Rate</i> <i>No Security</i>	<b>Cash Now</b> <i>Short Term</i> <i>Rapid Payments</i> <i>High Interest Rate</i> <i>Full Security</i>

# Potential Funding Sources



- » Life insurance
- » Cash
  - Life insurance
  - Corporate assets
  - External borrowings
  - “Sinking fund”
- » Selling shareholder notes
- » Combination of cash and shareholder notes

# Funding the Buy-Sell Agreement



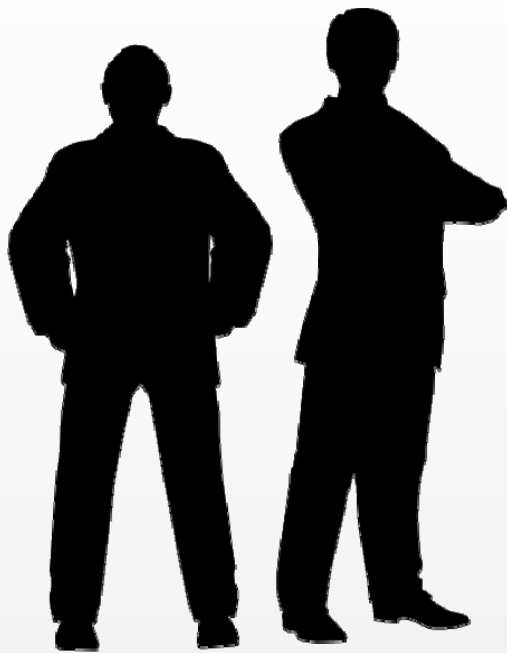
- » Life insurance typically purchased by company for corporate buy-sell agreements
- » Key question: Is life insurance intended as a

**Funding Vehicle**

OR

**Corporate Asset**

# True Story: Life Insurance



WHAT HAPPENS NOW?

# Funding Mechanism

What about Life Insurance Treatment for Valuation Purposes?



	Company	Harry (Estate)	Sam
<b>Proceeds are a Funding Vehicle</b>			
1 Stock Ownership (Shares)	100.0	50.0	50.0
2 Stock Ownership (%)	100.0%	50.0%	50.0%
3 Pre and Post Life Insurance Value (\$m)	<b>\$10,000.0</b>	<b>\$5,000.0</b>	<b>\$5,000.0</b>
4 Life Insurance Proceeds	\$6,000.0		
5 Repurchase Liability	(\$5,000.0)		
6 Post-Life-Insurance Value	<b>\$11,000.0</b>		
7 Repurchase Stock	(\$5,000.0)	\$5,000.0	
8 Retire / Give Up Stock	(50.0)	(50.0)	
9 Remaining Stock	50.0	0.0	50.0
10 New Stock Ownership (%)	100.0%	0.0%	100.0%
11 Post-Life Insurance Value of Co.	\$11,000.0	\$0.0	<b>\$11,000.0</b>
12 Post Life Insurance Proceeds		<b>\$5,000.0</b>	
13 Net Change in Value from Repurchase	<b>\$1,000.0</b>		

# Funding Mechanism

What about Life Insurance Treatment for Valuation Purposes?



	Company	Harry (Estate)	Sam
<b>Proceeds are a Corporate Asset</b>			
1 Stock Ownership (Shares)	100.0	50.0	50.0
2 Stock Ownership (%)	100.0%	50.0%	50.0%
3 Pre-Life Insurance Value (\$m)	<b>\$10,000.0</b>	<b>\$5,000.0</b>	<b>\$5,000.0</b>
4 Life Insurance Proceeds (\$m)	\$6,000.0	\$3,000.0	\$3,000.0
5 Post-Life Insurance Value (\$m)	\$16,000.0	<b>\$8,000.0</b>	\$8,000.0
6 Repurchase Liability	(\$8,000.0)		
7 Post-Life-Insurance Value	<b>\$8,000.0</b>		
8 Repurchase Stock	(\$8,000.0)	\$8,000.0	
9 Retire / Give Up Stock	(50.0)	(50.0)	
10 Remaining Stock	50.0	0.0	50.0
11 New Stock Ownership (%)	100.0%	0.0%	100.0%
12 Post-Life Insurance Value of Co.	\$8,000.0	\$0.0	<b>\$8,000.0</b>
13 Post Life Insurance Proceeds		<b>\$8,000.0</b>	
14 Net Change in Value from Repurchase	<b>(\$2,000.0)</b>		

# The Rest of the Story



*Becky L. Barkett, et al. v. American Veterinary Supply, Inc., et al.*

11 Circuit, Miami-Dade County, FL  
Case No. 06-14605 CA (32)

# Review

## Types of Buy-Sell Agreements



- » Fixed-price agreements
- » Formula agreements
- » Shotgun agreements
- » **Process agreements**



# Review

## The Six Defining Elements of Process Buy-Sell Agreements



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Qualifications of Appraisers

Level of Value

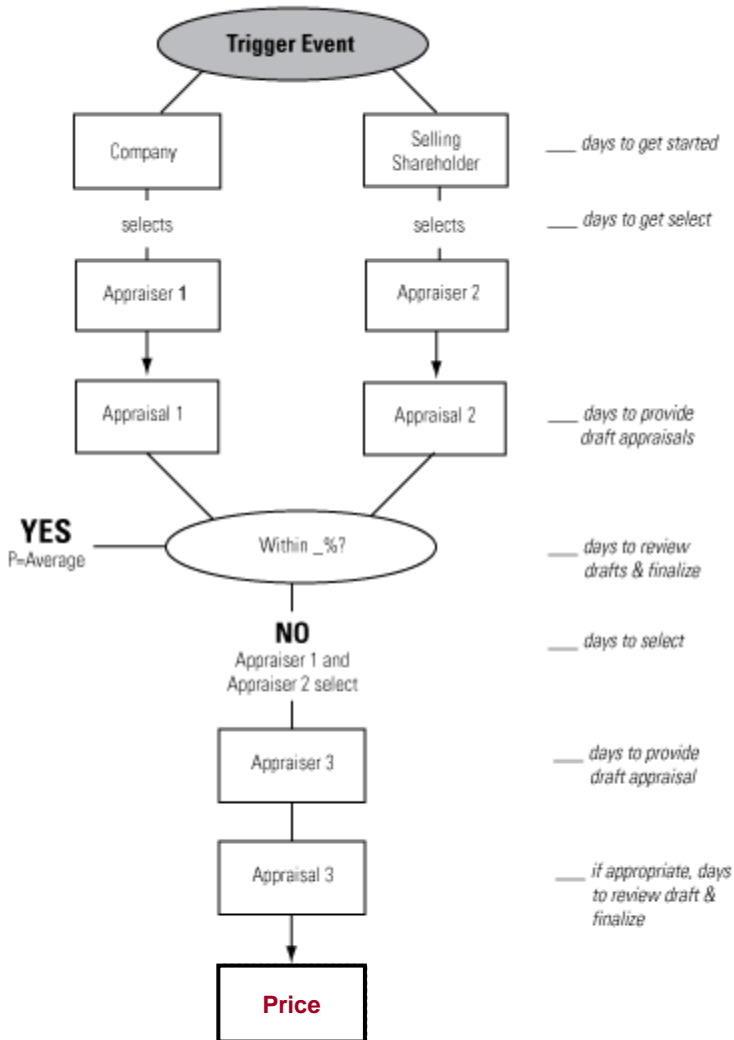
Appraisal Standards

The “As Of” Date

Funding Mechanism



## MULTIPLE APPRAISER PROCESS AGREEMENT

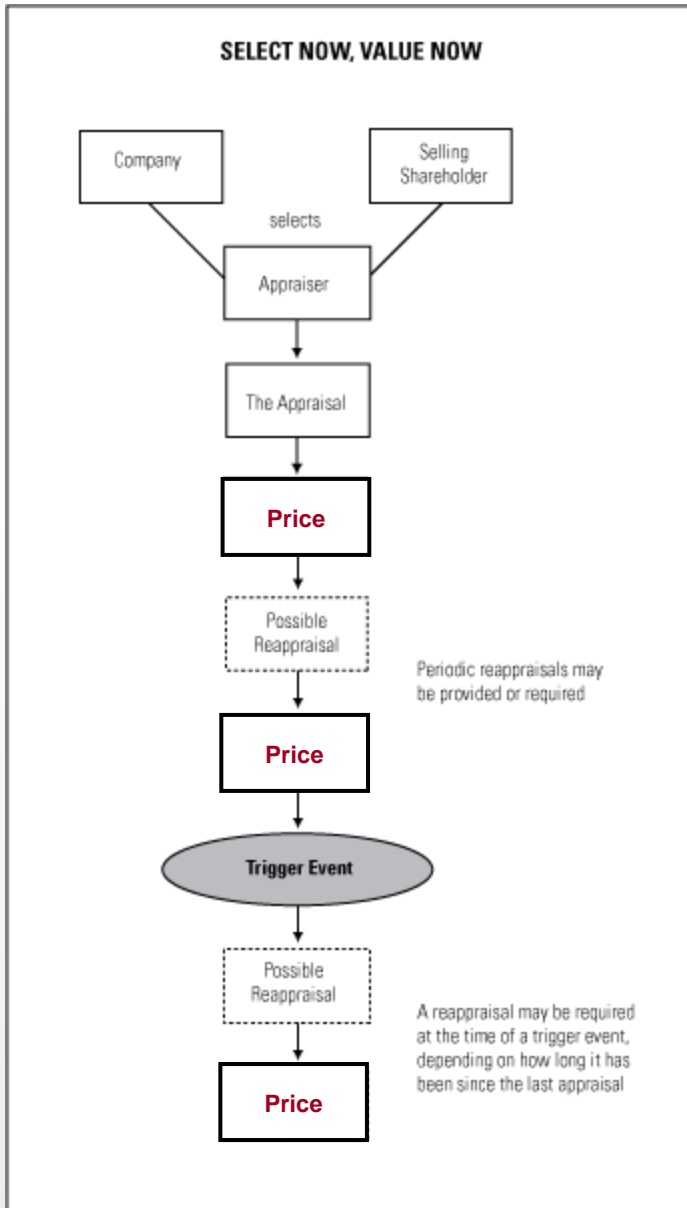


### Appraiser 3 is the Tie-Breaker

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## Review

# Multiple Appraiser Agreements



## RECOMMENDATION

# Single Appraiser Agreement

## Select Now and Value Now

**AVAILABLE  
NOW**

How to Know Your Agreement Will Work  
Without Triggering It



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Z. Christopher Mercer, ASA, CFA, ABAR

Foreword by Tom Deans, Ph.D.  
Author of *Every Family's Business*



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