

Buy-Sell Agreements: How to Know Your Buy-Sell Agreement Will Work Without Triggering It

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Proven valuation approaches and litigation strategies

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In Today's Session...

- Understand the types of buy-sell agreements
- Why valuation terms are a critical part of the agreement
- Some business aspects of the agreement
- Information to help you
 - Conduct a review of your agreement
 - Identify potential areas of concern
- A recommended solution to know if your buy-sell agreement will work before it gets triggered



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Trigger Events

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



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Types of Buy-Sell Agreements

Fixed Price Agreements

Formula Agreements

Process Agreements

Rights of First Refusals

Shotgun Agreements



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Fixed Price Agreements

Advantages

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

Disadvantages

- Out of date when inked
- 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 Inequities are almost certainly a result of out-of-date fixed price agreements.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, the greater the potential for a divergence of the interests of the various parties.
- **Betting that the other guy(s) will die first**



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Fixed Price Agreement "Stress Test"

- What is the date of the agreement?
- Is the agreement signed by all parties who should be subject to the agreement?
- Does the agreement call for periodic updating? Do you have a formal mechanism for ensuring that it is updated?
- Has the fixed price been updated to a current date? If not, how long has it been?
 - Regardless, is that price reasonable in light of the current market? What is your basis for gauging the current market?
 - Is the price "fair" to you? Other shareholders?



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Fixed Price Agreement “Stress Test”

- Has the company or the shareholders purchased life insurance?
 - Is the agreement explicit regarding life insurance treatment or silent?
 - If silent, is there room for disagreement among the parties upon a triggering event?
- If the company is the required purchaser, does it have the capacity to repurchase the largest interest?
- Does the agreement have an alternative resolution for pricing in the event that the fixed price is stale?



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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.”



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Formula Agreements

Advantages

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

Disadvantages

- No formula selected at a point in time provides reasonable and realistic valuations over time
- Changes occur in companies, industries, and local, regional, national, and world economies – some or all of which can impact the “true value” of an enterprise relative to any set formula
- Formulas, if not specified carefully, can be misinterpreted or are subject to multiple interpretations



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Formula Agreement "Stress Test"

- What is the date of the agreement?
- Is the agreement signed by all parties who should be subject to the agreement?
- Is an example calculation provided as an exhibit to the buy-sell agreement?
- Does the buy-sell agreement identify who is to make the price calculation upon a trigger event?
 - > Were any adjustments made in the initial calculation?



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Formula Agreement "Stress Test"

- Calculate, or have the two qualified persons independently calculate, the formula price according to the description in the agreement.
 - > Are the results identical?
 - > Were any adjustments made to balance sheet or income statement items?
- Is the formula price reasonable in light of the current market?
 - > What is the basis for gauging the current market?
 - > Is the price "fair" to you? Other shareholders?



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Formula Agreement "Stress Test"

- Has the company or the shareholders purchased life insurance?
 - > Is the formula explicit regarding life insurance treatment or silent?
 - > If silent, is there room for disagreement among the parties upon a triggering event?
- If the company is the required purchaser, does it have the capacity to repurchase the largest interest?
- Does the agreement have an alternative resolution for pricing in the event that the formula price is stale or if there is substantial disagreement?



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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

- Raises a question...



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How Do Appraisers Determine Value?

Your Buy-Sell Agreement
Tells Them How to Proceed



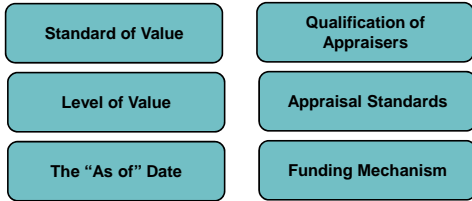
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Polling



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The Six Defining Elements of Process Buy-Sell Agreements



The "words on the page" must be crystal clear!



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Standard of Value

- Every valuation is defined in part by the standard of value
 - > "The identification of the type of value being used in a specific engagement..."
- Which standard of value?
- "Fair market value"
- Other possibilities
 - > "Fair value"
 - > "Investment value"
 - > "Going concern value"
 - > "The value"



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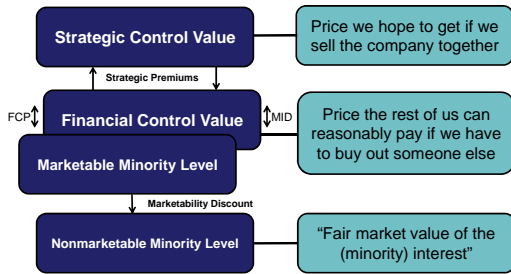
Key Takeaways: Standard of Value

- If language is anything besides "fair market value," be sure the alternative term is clearly defined in terms that appraisers will understand
- But then...
 - > The "fair market value" of what?



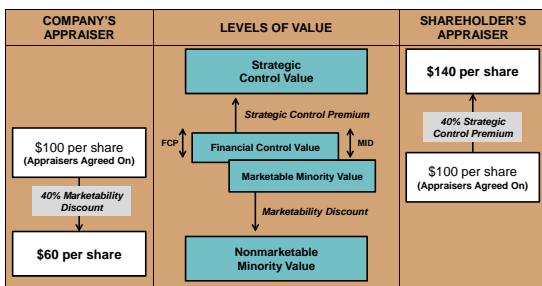
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If You Don't Decide, Someone Else Will Decide For You



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Here is an example of two qualified appraisers' different interpretations when the level of control was not specific in the agreement. Both appraisers agreed that the financial control/marketable minority level of value was \$100 per share.



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You now have two very different ending values which started at the same points of \$100 per share. Both appraisers relied on the agreement which had vague and confusing language regarding the level of value. So the appraisers decided on what they thought the agreement meant.

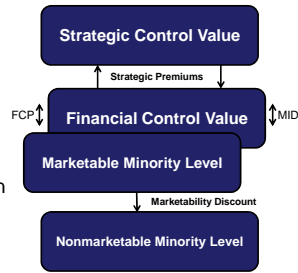
- How could this happen?
- How will it be resolved?
- Could this happen to you?



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Level of Value

- Parties should discuss and agree
 - Reflect in agreement
 - Unambiguous language
- If parties didn't agree before trigger event...
- Disagreements between appraisers regarding language?



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Key Takeaways: Level of Value

- If the level of value in your buy-sell agreement is specified with language other than the preceding discussion, have a qualified valuation professional review and translate
- If the level of value is not specified by reference to a chart, be sure the shareholders agree, and then fix it



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The "As of" Date

- "The specific point in time as of which the valuator's opinion of value applies" (also referred to as the "effective date" or "appraisal date")
 - Absent specification, appraisal process not grounded in time
- Other business issues related to the "as of" date
 - Lack of clarity as to rights of interest that is subject of the valuation process
 - After death
 - ✦ What is the interest?
 - ✦ Right to receive price per agreement?
 - ✦ Ownership interest in enterprise?
 - ✦ Rights to vote and receive distributions?



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Key Takeaways: "As of" Date

- Determine whether the "as of" date of the appraisal is tied to the trigger event, or some other specific date
- Then, determine if the ongoing rights of the affected interest are clearly specified



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Business Appraiser Qualifications

- Terms used to describe appraiser qualifications
 - > Appraiser
 - > Qualified appraiser
 - > Licensed general appraiser
 - > Investment banker
 - > Accountant
- Are all appraisers alike?
 - > Equally qualified?
 - > Equally experienced?
 - > Equally credentialed?
- Industry expert vs. valuation professional



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Key Takeaways: Business Appraiser Qualifications

- Does your agreement specify the qualifications of appraisers?
- While it's a good idea to specify qualifications of appraisers, it's better to select the appraisers now



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Business Appraisal Standards

- Credentialed business appraisers bound by one or more of the following business valuation standards:
 - > Uniform Standards of Professional Appraisal Practice (USPAP)
 - > American Society of Appraisers (ASA)
 - > American Institute of Certified Public Accountants (AICPA)
 - > National Association of Certified Valuation Analysts (NACVA)
 - > Institute of Business Appraisers (IBA)
- Non-credentialed appraisers...



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Key Takeaways: Business Appraisal Standards

- Make sure your agreement calls for qualified and credentialed business appraisers



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Funding the Buy-Sell Agreement

- Most buy-sell agreements with companies of significant size and ownership greater than 2-3 shareholders are structured as corporate purchase agreements
- Life insurance typically purchased by company
- Key question: Is life insurance intended to be...

Funding Vehicle

OR

Corporate Asset



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Multiple Appraiser, Single, or Hybrid Agreement

• Advantages

1. Provide a defined structure
2. All parties know, at least generally, what the process will be in advance
3. Fairly commonly known and generally understood by attorneys (who know the problems with fixed price and formula agreements)
4. Illusory benefit – false sense that “my appraiser” will protect “my interests”

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Multiple Appraiser, Single, or Hybrid Agreement

• Disadvantages

1. Price *not* determined now
2. Potential for dissatisfaction with the process for all parties
3. Danger of advocacy
4. Uncertainty over what happens at trigger event
5. Uncertainty over final price if the process is invoked
6. Problems with any other aspect of the operation of the agreements are deferred until a trigger event
7. Expensive
8. Time-consuming
9. Distracting for management
10. Potentially devastating for affected shareholders and their families

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Process Agreements “Stress Test”

- Is there a reasonable probability that the agreement will operate to effectuate a reasonable transaction when trigger events occur?
- Are all shareholders – who should be subject to the agreement – parties to the agreement?
- Do the shareholders who are parties to the agreement understand how the agreement will operate to determine prices and terms for future transactions?
- Has the agreement been reviewed by legal counsel to ensure compliance with applicable laws and statutes?
- Are the rights of the interest subject to the buy-sell agreement clearly defined after the trigger event?



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Process Agreements “Stress Test”

- Are the six defining elements of value as outlined in this presentation clearly specified?
- Will the pricing mechanism provide a reasonable value if and when trigger events occur in the future? How do you know?
- If the buy-sell agreement were triggered today, would its operation yield a price that is “fair” in light of the current market?
 - What is your basis for gauging the current market?
 - Would that price be “fair” to you? Other shareholders?
- Is the treatment of life insurance clearly specified for valuation purposes?
- How do you resolve differences?



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Stress Test Continued: Buy-Sell Audit Checklist

- Nature, size, and ownership of entity
- Trigger events for consideration
- Fixed price agreements
- Formula agreements
- Defining value for purposes of process (appraisal) agreements
- Process buy-sell agreements: multiple appraiser options
- Process buy-sell agreements: single appraiser options
- Process buy-sell agreements: single appraiser agreement with multiple appraiser options
- Financial statements to be used
- Process timetables
- Who bears the cost of the appraisal(s)?
- Tax pass-through entity appraisal issues



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The Solution



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Your or your client's
buy-sell agreement
should be...

Understandable

Predictable

Likely to
achieve
reasonable
resolutions

Helpful in the
wealth
management
process



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Recommendation

Single Appraiser

Select Now, Value Now

Value Regularly



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Single Appraiser Agreements: Select Now and Value Now

• Advantages

1. Selected appraiser viewed as independent
2. Appraiser's valuation process is seen by all parties at the outset
3. Appraiser's conclusion is known at outset and has established a baseline price for the agreement
4. Because process is observed at the outset, all parties know what will happen when trigger event occurs
5. 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
6. Selected appraiser must maintain independence with respect to process and render future valuations consistent with terms of agreement and with prior reports



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Single Appraiser Agreements: Select Now and Value Now

• Advantages (continued)

7. Subsequent appraisals, either annually or at trigger events, should be less time-consuming and less expensive than other alternatives
8. Parties should gain confidence in the process
9. Parties will always know the current value for the buy-sell agreement (helpful for planning all-around)
10. Appraiser's knowledge of the company and its industry will grow over time, enhancing confidence for all parties with the process
11. Creates a means of maintaining pricing for other transactions, thereby enhancing "the market" for a company's shares
12. When we do valuations absent issues of a triggering event, we almost always find opportunities for increasing and protecting shareholder value. The buy-sell is a protection device, but many times there is a transaction before a triggering event.



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Recommendation

Single Appraiser

Select Now, Value Now

Value Regularly

- Good for you or your clients' businesses
- Excuses, excuses, excuses...No excuses, really
 - The One Percent Solution and wealth management
 - Elimination of uncertainty in corporate and personal planning

Questions / Comments



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Thank you for attending our webinar

➤ We hope you gained useful knowledge and tools that you can apply to your buy-sell agreement(s) right away. Please contact us with further questions or for discussion:

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- Return your completed evaluation form to Nancy at NMoore@vslip.com today to receive your certificate of completion for MCLE or CPE credit.
- Email NMoore@vslip.com for your chance to win "Buy-Sell Agreements for Closely Held and Family Business Owners". In the email subject, be sure to type "buy-sell". We'll randomly draw 3 winners at 12:00 PM today.



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