Part II

Your Buy-Sell Agreement

Ticking Time Bomb or Reasonable Resolution?

Most privately owned companies have buy-sell agreements. They call for the purchase, either by other shareholders or by the company, of shares owned by a shareholder upon certain "trigger" events, some of which we term "**QFRDD**:" employees **Q**uit, are **F**ired, **R**etire, become **D**isabled, or **D**ie (divorce and bankruptcy are other trigger events).

These events are called trigger events because when they happen, it can sometimes feel like there is a gun to your head. So it is critical that your buy-sell agreement function like they and other shareholders who are parties to the agreement would like it to when a trigger event occurs. Unfortunately, most do not.

Many buy-sell agreements are written to call for a business appraisal process when trigger events occur. Sometimes, agreements call for a fixed price to be updated periodically by the shareholders. Many of these fixed price agreements, in the often likely event that the price is not updated, also call for an appraisal process.

Our experience tells us that most business owners are typically not familiar with the process in their agreement. While there are many varieties of processes, a typical process can be described:

> Following a trigger event, the shareholder selects an appraiser and the company selects another. They both provide appraisals. If they are within 10% or so of each other, the concluded price is the average of the two. If not, the first two appraisers select a third appraiser who then provides a conclusion.

One way or another, the third appraisal mentioned above brings resolution to the process, either by averaging with the other two, by averaging with the one closest to it, or in some other fashion.

If this process seems fairly straightforward, don't let it deceive you. While it may appear clear-cut, it does not contain sufficient information for a business appraiser to work with. Where there is ambiguity, there are problems. Because ambiguity abounds in buy-sell agreements, far too many valuation processes turn into disasters for the participants, gobble up enormous amounts of time and money, and create great emotional angst for all.

One company president received my book, *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?*, following a tortuous valuation process at his company. His comment after reading it was "I just wish we had seen the book before all this happened to us. We would have changed the agreement to avoid all the problems that we didn't realize were problems!"

If you want your buy-sell agreement to provide a reasonable resolution when trigger events occur, six things need to be included to define the *valuation* process and ensure a good *business* process.

1. ***Standard of value.*** This is a valuation term relating to the overall type of value. *Fair market value* is a common standard used in buy-sell agreements. This standard is well-known by business appraisers and attorneys. Fair market value is the hypothetical price at which willing buyers and willing sellers, both reasonably informed and neither with compulsion and both with capacity, engage in a transaction. If the agreement says something else, be sure the parties know what it means and that business appraisers will interpret it similarly.

2. ***Level of value.*** The so-called level of value concept relates to the particular kind of value the agreement specifies. Do the parties desire that the price be that of a nonmarketable minority interest, or a pro rata share of the value of the business? Or should the value be that which is obtainable in a sale to a strategic buyer? Many agreements try to specify this concept, but fail to obtain valuation advice. Lack of clarity on this point will create great confusion and busted valuation processes.

3. ***The "as of" date.*** The "as of" date is the valuation date. One wouldn't think there could be confusion on this point, but a number of agreements fail to specify the "as of" date clearly. Imagine the problem if two different business appraisers interpret the "as of" date to be different dates, significantly apart in time. The agreement needs to be crystal clear on this point.

4. ***Qualifications of appraisers.*** Many agreements call for each party to retain the services of "an appraiser," "a qualified appraiser," or another description. The qualifications of the business appraiser(s) need to be specified in your agreement. For example, the agreement might read something like this: "Each party will retain the services of a business appraiser. To be considered, an appraiser must be an Accredited Senior Appraiser as designated by the American Society of Appraisers [or, you pick the designating body] and must have experience in valuing companies of similar size and scope as the Company." Designating specific industry experience might be attractive; however, be aware that some industries are so small or discrete that there are no real industry experts. Even if an industry has acknowledged industry experts, their valuation expertise may be lacking. Therefore, it is always a better idea to seek valuation expertise over industry expertise.

5. ***Appraisal standards to be followed.*** Most of the major business appraisal organizations have recognized appraisal standards for their members to follow. The most widely known and accepted business appraisal standards include the *Uniform Standards of Professional Practice (USPAP)*, issued by The Appraisal Foundation, and the *Business Valuation Standards* of the American Society of Appraisers. Business appraisers accredited by the American Society of Appraisers are required to follow both of these sets of standards. Other organizations, including the Institute of Business Appraisers, the National Association of Certified Valuation Analysts, and the AICPA also issue standards. The agreement should ensure that all business appraisers follow the same set(s) of appraisal standards, otherwise confusion and misunderstanding can easily occur. What you definitely do not want is an unqualified business appraiser who follows no standards.

6. ***The funding mechanism.*** While the funding mechanism is not normally involved in defining the valuation (unless, for example, life insurance proceeds are involved), it is important to establish the funding mechanism for the buy-sell agreement. This may be as straightforward as defining the terms of payment, including the specification of the terms of any note that would be required. However, this requires careful consideration, especially if there is other debt on the company's balance sheet.

Is your buy-sell agreement a ticking time bomb? Or will it provide for a reasonable resolution when the next trigger event occurs? You can affect the answer if you act now, before a trigger event. Review the buy-sell agreement. The recognition that these agreements contain potential problems is fairly new among business appraisers and attorneys. If there are potential misunderstandings in the agreement, it is not a matter of blame – it is about dealing with potential problems so that when trigger events occur, the process will work as all parties to the agreement intended when it was signed.

Hopefully, you will consult the services of a qualified business appraiser to help work through the business and valuation provisions of the agreement. There is a 40-plus page checklist in *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?* to assist you in this process.

Forewarned is forearmed. Let your buy-sell agreement be a reasonable resolution for your company and all the shareholders who are parties to it, rather than a ticking time bomb.

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