

**Baby Boomer Business Owner Transition Guide**

# **BUY-SELL AGREEMENTS**

**for Baby Boomer  
Business Owners**

**Z. Christopher Mercer, ASA, CFA, ABAR**

**The Baby Boomer Business Owner Transition Guide Series**

# **Buy-Sell Agreements for Baby Boomer Business Owners**

by

Z. Christopher Mercer, ASA, CFA, ABAR

*Is Your Buy-Sell Agreement a Ticking Time Bomb or Will It Provide a Reasonable Resolution for You, Your Family and Fellow Owners When Triggered?*

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ISBN: 978-0-9700698-4-9

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Published by  
**Peabody Publishing, L.P.**  
5100 Poplar Avenue Suite 2600  
Memphis, TN 38137



## Prologue

# Overview of This Kindle Book

### **WHY A BOOK ON BUY-SELL AGREEMENTS FOR BABY BOOMERS?**

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According to the U.S. Census Bureau, a baby boomer is defined as someone who was born during the demographic post-World War II baby boom (1946 – 1964). Today, the baby boomer generation ranges in age from close to 50 to about 67 years old. I am a business valuation professional, a business owner, and a boomer from the early part of the population wave so I understand the opportunities and challenges we face today.

As a boomer business owner yourself, you have undoubtedly made many transitions in your life so far. Now, you are either making or will be making additional life and business transitions in the coming months or years.

You will, for example, transfer your business ownership interests to someone. You may do that willingly and according to a plan that you execute in logical fashion. Or, you may do that unwillingly, at the point you surrender those interests when you die. Or, you may not have a plan and life will happen and your business interests will transfer anyhow.

This book is about you and your buy-sell agreement – or agreements if you share ownership in multiple entities. This buy-sell agreement is part of your plan for the future and if it fails to operate well when it is triggered for you or any of your fellow owners, the results can range from bad to disastrous.

You see, buy-sell agreements are not merely legal documents to be signed and forgotten. Are you sure you know what will happen when your agreement is triggered? If not, this book is for you. It provides critical information and insights you won't find anywhere else – information that can save you and/or your heirs money, as well as possibly control of your business.

I make the bold assertion that your current buy-sell agreement has problems that will likely preclude it from working the way you and the other shareholders planned – in terms of pricing, terms and process – when triggered. How do I know?

I have worked with closely held and family businesses for more than 30 years and have reviewed hundreds of buy-sell agreements from business and valuation perspectives. I've also been witness to the valuation processes of many buy-sell agreements after being retained times following the deaths or firings or whatever else happened that triggered them.

I see the same problems over and over again. These are problems that attorneys and other advisors overlook because they relate to either to valuation or business issues or both.

To your **business attorney**, your buy-sell agreement may be just another legal document. It is more than that.

To your **tax attorney**, your agreement may or may not determine the fair market value of your interest at your death. That is not good.

To your **financial planner**, the agreement may be an integral part of your overall plan, but he or she may not know how it will function. If she doesn't know how value will be established for your interest in the business, your financial planning may be in jeopardy.

To your **accountant**, it may or may not mean anything, depending on the nature of relationship you have. Often, a company's CPA is involved in certain planning activities like buy-sell agreements. However, if the same CPA is not aware of the personal financial situations of the owners, the resulting advice will be incomplete at best.

To your **insurance executive**, it may determine the amount of life insurance that is purchased in the event of the death of one or more of the owners. This is important, but does your agreement properly dictate what happens to the life insurance proceeds. If not, disaster can be the result.

To you and your **fellow owners**, the buy-sell agreement dictates what will happen when bad things (deaths, firings, etc.) happen. Something will happen to you and/or to your fellow owners because life happens to all of us.

So, your buy-sell agreement is a critical lifetime and ownership transition planning document. Will it work the way you and your fellow owners expect? The answer to this question is too important to leave to chance.

Unless you have commissioned one of your advisers, e.g., your financial planner or your attorney or your CPA, to work with various other appropriate professionals, then your buy-sell agreement will not be coordinated and you are leaving the happening of major future transactions to chance.

You can, of course, try to do all of this coordinating yourself, but we boomers have proven collectively that we are not good at it. So put a "transition leader" in charge. You likely will have to pay someone to help you coordinate your transition planning activities. Just accept this fact as a cost of managing your illiquid wealth. You certainly pay management fees for liquid wealth in tax-deferred plans or held with money managers. So just do it, starting with your buy-sell agreement.

If you still don't believe me, invest a few minutes and read Chapter 1, "Pete and Sam – A Buy-Sell Agreement Story." You might just recognize yourself and your situation.

Life is a journey. Not a destination. As business owners, we should always be transitioning into the next phases of our lives. I hope that this book on buy-sell

agreements, which are transition vehicles in their own right, helps you and your fellow owners examine and correct any problems in your agreement – before a trigger event happens.

Other books in my Baby Boomer Business Owner Guide series will be published soon, so, please be on the look out for them.

## **WHAT IS A BUY-SELL AGREEMENT SUPPOSED TO DO?**

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Buy-sell agreements govern how ownership will change hands if and when something significant, called a trigger event, happens to one or more of the owners. These agreements are intended to ensure the remaining owners control the outcome during critical transitions. They specify what happens to the ownership interest of a fellow owner who dies or otherwise departs the business, and mandate that a departing owner be paid, hopefully reasonably, for his or her interest in the business.

Buy-sell agreements are supposed to work by:

**Providing a market for the shares** (or partnership interests or member interests) in the event an owner dies or has to leave the company.

**Establishing the price and terms** for the market so future transactions under the buy-sell agreement occur in an orderly and reasonable fashion.

**Specifying financing** (or life insurance or cash) is available to acquire shares in the event an owner departs.

In this book, we describe valuation processes involving one, two, or three business appraisers for determining the price for buy-sell agreement transactions. I have been the first or second appraiser selected by the sides in many valuation processes. I have also been the third appraiser selected by the first two appraisers in many more situations.

These experiences all inform my understanding of buy-sell agreements and how they work from business and valuation perspectives. In addition, I have personally been a party to several buy-sell agreements at my firm, Mercer Capital, and at other companies where I have been an investor.

## **AN INTRODUCTION TO THE THREE TYPES OF BUY-SELL AGREEMENTS**

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This book goes into great detail about the different types of buy-sell agreements in Chapters 6, 7, 10, and 11. The material that follows here is meant as an introduction to the topic to help you identify the type of agreement you currently have.

Buy-sell agreements have three basic types of pricing mechanisms: 1) some have fixed prices; 2) others use a formula mechanism to set the price; and 3) still others use a valuation process to determine price. Regardless of the type, one critical purpose of buy-sell agreements is to set the price for future transactions.

## 1. Fixed-Price Agreements

**Description.** You and the other owner(s) agree(d) on a price and set it in the buy-sell agreement. 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 a realistic value.

The value today is higher, perhaps far higher, than a realistic value.

The value is the same as it was back then.

*You almost certainly, based on my experience, 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?*

## 2. Formula Price Agreements

**Description.** You and the other owner(s) establish(ed) 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 when the formula provides an unreasonable (from someone's viewpoint) result.*

**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?*

### 3. Valuation Process Agreements

**Description.** You and the other owners agree that if the buy-sell agreement is triggered, you will bring in one or more business appraisers to determine the price. Essentially, 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.*

Your company’s buy-sell agreement has one (or possibly a combination) of these pricing mechanisms. This reality will hold true whether the agreement is between the owners and the company (an entity agreement) or between you and your fellow owners (a cross-purchase agreement).

#### **ONE BABY BOOMER’S LUCKY EXPERIENCE – MINE**

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The first two buy-sell agreements at my firm, Mercer Capital, were in existence for a period of 24 years. Both were fixed price agreements. We never updated the prices even though we knew better. If we didn’t update the prices, I’m sure you haven’t either – despite your best intentions.

Nothing happened to any of the shareholders during that period of time. We were lucky. Since I owned the majority of the stock in the firm during that entire period, my family was lucky, because our value was growing steadily over the years.

Since early 2006, we have had a buy-sell agreement that follows the main recommendation of this book. I am now practicing what I preach to my fellow baby boomers.

## THE MAIN RECOMMENDATION OF THIS BOOK

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Based on more than 30 years of experience working with business owners and the buy-sell agreements of their companies, I have reached the following conclusion:

The best valuation mechanism for the buy-sell agreements of most successful closely held and family businesses is a single appraiser valuation process. This process, called the *Single Appraiser, Select Now and Value Now* process, is discussed in more depth in Chapter 11.

This valuation process is summarized below so you will better understand the reasoning.

## THE “SINGLE APPRAISER, SELECT NOW AND VALUE NOW” PROCESS

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This valuation process can be summarized beginning at the time of agreement between the various owners and the business. Initially:

**The parties agree on a qualified independent business appraiser.** Chapter 8 outlines business appraiser qualifications and provides guidance for the selection process. Since there is no trigger event, the parties should be able to discuss and agree on a qualified business appraiser.

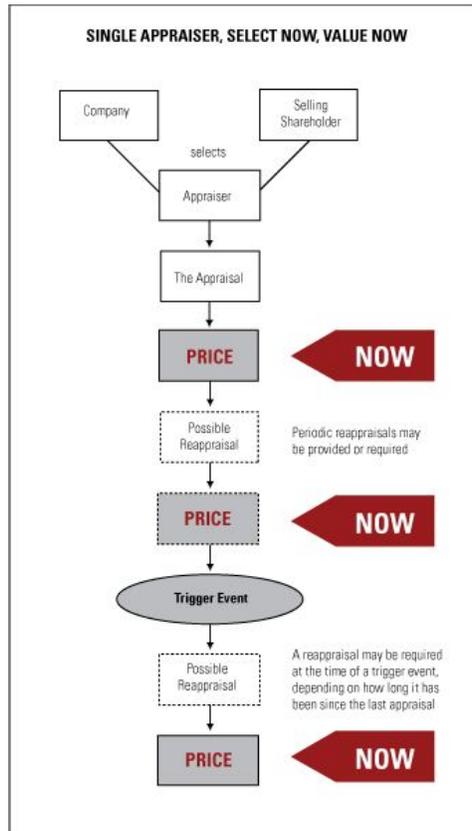
**The business appraiser defines the valuation engagement as specified in the buy-sell agreement.** As part of his or her assignment definition, you will be asked to specify the standard of value (like fair market value) and the level of value that the owners have previously agreed on and that is reflected in your buy-sell agreement.

**The business appraiser provides an initial draft valuation of the business.** All parties to the agreement (or their designated representatives) should review the draft valuation. This is an opportunity to ask questions of the appraiser and to provide any additional input related to things that might have been overlooked or misunderstood. If there is any misunderstanding about the kind of value the appraiser should be providing, it can be fixed (and language in the agreement amended) based on conversations with the appraiser and counsel.

**After receiving all input from the parties, the appraiser finalizes the valuation.** Upon finalization, the appraised value sets the price for purposes of the buy-sell agreement until the next appraisal. For companies with value of \$3 to \$5 million or more, this should be every year, or at the very least, every other year.

**The appraiser provides a reappraisal every year (or every other year).** The annual appraisal resets the price for the buy-sell agreement until the time of the next following reappraisal. The parties can, of course, agree that if \_\_\_ months (you pick) have passed since the last appraisal and before the regularly scheduled reappraisal, either party can ask for a current appraisal as of the date of the triggering event.

The following chart depicts the *Single Appraiser, Select Now and Value Now* process graphically.



This process is simple and straightforward. The advantages of the process are outlined in Chapter 11 at length. For now, the main benefits are summarized:

1. The parties know what the current price for the buy-sell agreement is at all times and how that price is determined. This knowledge facilitates estate tax planning for the owners, life insurance funding for the company (or the other owners if there are cross-purchase agreements).
2. Unanticipated problems with the valuation process set forth in your buy-sell agreement are identified and fixed prior to any triggering events.
3. At the occurrence of a trigger event, the valuation process is known and specified, thereby eliminating (or minimizing) problems that we will discuss with the other forms of pricing mechanisms.

The *Single Appraiser, Select Now and Value Now* process is recommended because of its many benefits to owners of closely held and family businesses. Here are only two brief examples, taken from a list of over 100 companies for whom my firm provides annual appraisals.

One firm, for example, has obtained at least one independent appraisal per year for the past 25 years for purposes of its buy-sell agreement. This has facilitated the transfer of ownership now well into the third generation of the controlling family. Every transaction that has occurred, whether for gift purposes, for the sale of stock by a family member, or for the repurchase of shares by the company, has occurred at the then-current appraised price.

Another company obtained at least one appraisal per year for more than 20 years. The shareholder base is broader in this example, and the appraisals have been used for the profit sharing plan, employee stock purchases, company stock repurchases, arms' length transactions with outside parties, and other corporate purposes. In addition, the appraisals, appropriately adjusted for facts and circumstances, have been used for gifting and estate tax purposes.

The bottom line is that the *Single Appraiser, Select Now and Value Now* valuation process is the best process to provide the valuation mechanism for buy-sell agreements for most businesses.

## A PLAN OF ACTION

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The truth is whether your buy-sell agreement has a fixed-price, is a formula agreement, or contains a valuation process, chances are that you, the other owners, and your company are in for a surprise when it is triggered.

The cost of this book is insignificant. What is important is your time. If you invest the time to read it, I promise you will gain understanding and learn tools to eliminate this danger from your business and your life. As such:

I recommend that you read this guide aggressively.

Highlight relevant facts or issues for further study.

Raise questions or make notes to focus your thinking about buy-sell agreements generally, or about your agreement specifically.

If you have an existing buy-sell agreement, read it in conjunction with this book. If you have a partnership or LLC, the buy-sell provision may be included in the basic agreement. Raise questions in your agreement and add to your notes. The *Buy-Sell Agreement Review Checklist*, written for use with this book, is available for you to download at [www.buysellagreementsonline.com](http://www.buysellagreementsonline.com).

If you are initiating a buy-sell agreement at the time you are reading this book, make notes relating to your situation. Then, consolidate your notes on the *Buy-Sell Agreement Review Checklist* before discussing them with legal counsel or other business advisors. If these professional advisors are participating in the process with you, work through the checklist together.

Share the book with your fellow shareholders and use the *Buy-Sell Agreement Review Checklist* to facilitate the discussion.

Have a valuation professional read your buy-sell agreement from valuation and business perspectives to identify potential problems.

Have your financial planner or tax attorney read the buy-sell agreement to determine if it is consistent with your personal estate planning.

Use this book as an active tool to help you, your lawyers, and other advisors craft workable agreements. Is your buy-sell agreement a ticking time bomb? Or will it provide a reasonable resolution for the future transactions it contemplates? The problem is up to you to resolve. We baby boomers do not have time to wait.

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## Chapter 1

### Pete and Sam – A Buy-Sell Agreement Story

If your buy-sell agreement is like the great majority of agreements I have seen, it will not work to provide reasonable resolutions when it is triggered. Yours could be an exception to this rule I have experienced in business life, but I doubt it.

Let's talk about buy-sell agreements, and in particular, your agreement. As part of our conversation, you can listen in on a composite, mostly true discussion I am having with a business owner named Sam. I am acting as his advisor, Pete, which was my father's nickname for me.

The story lasts several pages. After reading it, you will have a pretty good idea of where this book is headed and what I recommend that you consider for your buy-sell agreement.

Sam owns 40% of a successful closely held company. He and his long-time business partner set up a buy-sell agreement when they started their business almost 20 years ago. Sam is 60 years old and his partner, George, is 64.

My purpose in talking to Sam is to help him understand the actual issues he has with his buy-sell agreement and to encourage him, together with the other owners of the business, to take action. Sam, like you in all likelihood, passively assumes that his buy-sell agreement will work. In reality, it's like a time bomb.

#### THE STORY BEGINS

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**Pete:** “Sam, I just buried a small bomb in your yard. It isn't large enough to kill you, your wife, or any of your grandchildren, 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 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.”

If you knew there was a bomb in your yard that could harm you or your family, you would not stop until you found it and had it disarmed.

If you are like most owners of private businesses, your investment in the business represents a substantial portion of your net worth – maybe almost all of it. So when I talk about a bomb in the company yard, I’m talking about a bomb that can determine the timing of and return you get on your largest investment.

There is no bomb in your yard, but you almost certainly have one lurking within the words on the pages of your buy-sell agreement. If you haven’t done anything to fix it, you and your fellow owners need the equivalent of the bomb squad. By inaction, you have likely placed yourself, your families, and your company in real danger. This analogy is the clearest way I can communicate to you the importance of disarming this bomb before it explodes.

Sam has saved and invested wisely over the years and has a liquid investment portfolio worth about \$6 million. He is well on his way to a comfortable retirement, but the value of his 40% interest in his company is an important element in his retirement planning.

George, on the other hand, while a bit closer to retirement, has been less frugal and has less than \$1 million put away. He and his family are much more reliant on his receiving reasonable value for his 40% interest in the company.

The fact is, neither Sam nor George can afford the costs of an explosion resulting from their buy-sell agreement.

The conversation between Pete and Sam continues at dinner the next evening.

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**Pete:** “Sam, how many owners are there in your business?”

**Sam:** “We have four owners. My long-time partner, George, and I own 80% of the business between us. William and Don, who we brought in about 10 years ago, now own 10% each.”

**Pete:** “How long has it been since you had a conversation with George about your buy-sell agreement?”

**Sam:** “It has been quite a few years.”

**Pete:** “And how about with William and Don?”

**Sam:** “Well, we never really talked about it other than to tell them they had to sign the agreement if they became owners.”

**Pete:** “Sam, I can’t tell you how important it is for you guys to talk to each other about it.”

**Sam:** “I know. You keep saying that. But it is just hard to talk about the buy-sell agreement. Things get kind of testy when the topic comes up, so we just keep putting off talking about it.”

Sam is right, of course. Things can get kind of testy when owners talk about buy-sell agreement terms. It is human nature that we all don’t agree on every issue. As we get older and our lives develop separately, it becomes more difficult to talk. But we can normally reach a workable agreement on issues if we talk about them while our interests are generally aligned. After a trigger event, it is too late.

The conversation continues a few days later.

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**Pete:** “Sam, I really enjoyed dinner the other night.”

**Sam:** “I did as well, Pete. Thanks for picking up the tab.”

**Pete:** “It was my pleasure. I’m glad you agreed to meet with me today. When we began to talk about your buy-sell agreement the other night, you seemed a little worried and anxious about it. So here we are. We’ve both set aside a few hours, so let’s see what we can accomplish.”

**Sam:** “Sounds good to me!”

**Pete:** “You reacted pretty strongly when I told you your buy-sell agreement was a ticking time bomb that needed attention now.”

**Sam:** “You haven’t even read it yet! Don’t worry, I brought a couple of copies of the agreement as you suggested.”

**Pete:** “Great! You know, I hate to say it, but I don’t even have to read your agreement to know that something is wrong with it. I just don’t know what at this point.”

**Sam:** “Well, what might that be?”

**Pete:** “Well, let me ask a few questions first. How long has it been since you put your buy-sell agreement in place?”

**Sam:** “Looks like we signed it almost 14 years ago.”

**Pete:** “Has anyone reviewed the agreement since then?”

**Sam:** “You mean, like by our lawyer, or just internally?”

**Pete:** “Either or both.”

**Sam:** “Well, I suppose that William and Don read it when they became shareholders, about 10 years ago. I don’t think our attorney has read it in years. I know I haven’t asked him to look at it, and I don’t think George has either.”

It is surprisingly common that no one is familiar with a company’s buy-sell agreement. Even if everyone read an agreement at some point, memories fade over time. The attorney who drafted an agreement may have retired or changed firms. Buy-sell agreements fall out of sight and out of mind until trigger events and then it is too late to fix things.

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**Pete:** “Is your company a party to contracts or agreements with other businesses?”

**Sam:** “Quite a few. We have several important supplier relationships that are contractual in nature. And, we have contracts with our largest two customers.”

**Pete:** “Do you or your attorney review these when they are signed?”

**Sam:** “Of course we do. It would be irresponsible not to.”

**Pete:** “Do these contracts get adjusted or amended over time?”

**Sam:** “Sure. We have to keep them current in order to be sure that our key business relationships will run smoothly. When things change, the contracts have to be changed accordingly.”

**Pete:** “And how long has it been since your buy-sell agreement was reviewed?”

**Sam:** “OK, OK. I see what you are talking about.”

Your buy-sell agreement should be reviewed by you and your fellow owners every other year or so. It is clear that George and Sam did not think about whether any amendments were appropriate when they brought William and Don into the ownership group.

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**Pete:** “Sam, how is your company organized?”

**Sam:** “What do you mean?”

**Pete:** “I know you are incorporated, but are you a C corporation or an S corporation?”

**Sam:** “We are an S corporation now, but we used to be a C corporation.”

**Pete:** “When did you change?”

**Sam:** “Well, when we brought William and Don on board about 10 years ago, our accountant suggested that we make an S corporation election. He said that with our growing success and new owners, it would be difficult to bonus out all the earnings and it would be better to make distributions.”

**Pete:** “Did you make any changes to the buy-sell agreement after you changed corporate forms?”

**Sam:** “Pete, you know the answer already. We haven’t changed a single thing since we signed it 14 years ago.”

We know that many buy-sell agreements in S Corporations contain provisions requiring distributions for tax purposes. William and Don would certainly have wanted this protection if they had thought about it. Also, most S Corporation agreements include provisions prohibiting any owner from taking action or transferring shares in a manner that could jeopardize the S Corporation’s status.

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**Pete:** “Sam, when you put your buy-sell agreement together 14 years ago, how much time did you spend on it?”

**Sam:** “Well, as I recall, George and I met with our attorney for a couple of hours and we talked about a few things. Then, we got a draft of the agreement back. George and I were going to meet to go over it, but that never happened. I guess I spent about half an hour reading it over before I signed it.”

**Pete:** “And how about George?”

**Sam:** “I think it is safe to say he never read it at all. He just hates to read any of the legal stuff and leaves that to the rest of us.”

**Pete:** “What about William and Don?”

**Sam:** “When they came on board as owners, I told them to look over the buy-sell agreement because it was important they sign on as parties to it. Our attorney told me to be sure I told him when we were taking on a couple of new shareholders. I told them to ask our attorney if they had any questions.”

**Pete:** “Did they talk to the attorney?”

**Sam:** “No, I don’t think so.”

**Pete:** Do you know for sure that they signed the agreement?”

**Sam:** Well, they were supposed to, but I can’t tell you for sure because I never saw the documents. I assume our attorney has the document.”

It is not uncommon that shareholders retain independent counsel to review buy-sell agreements. Certainly a company’s counsel is in a position of conflict in this regard. A review by independent counsel for William and Don 14 years ago might have caused some changes to be made in the agreement.

One of the questions I always ask is whether all parties who should be parties to a buy-sell agreement are actually parties. It is not uncommon that, over time, as companies add owners, that all the appropriate parties have not signed their agreements. That’s another reason I recommend that buy-sell agreements be reviewed every couple of years by all relevant parties.

We will assume that William and Don have signed the agreement for purposes of the continuing conversation.

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**Pete:** “Sam, do you know what events will trigger your buy-sell agreement?”

**Sam:** “Well, if one of the shareholders dies, the company has to buy his stock. So I guess that is what you call a ‘trigger event.’ I think the agreement says something about what happens if one of us retires or becomes disabled, but I can’t remember the particulars.”

**Pete:** “What does the agreement say if one of the owners gets divorced?”

**Sam:** “I think there’s something in there, but I can’t remember what it says.”

**Pete:** “What if the actual language in your agreement came from some form?”

**Sam:** “Now that’s a scary thought!”

Agreements are sometimes silent regarding some potential trigger events. When specific trigger events are considered it is imperative that the owners understand them.

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**Pete:** “Sam, there are three basic categories of buy-sell agreements. In cross-purchase agreements, the owners agree to buy the other owners out if something happens. In entity agreements, the company does the buying. And finally, there

are hybrids, which can go either way. What category does your agreement fit into?”

**Sam:** “Well, when we put in the ‘new’ buy-sell agreement – you know, the one we did 14 years ago – we decided to have the company do the purchasing if anything happened.”

**Pete:** “Was there an agreement in place before that?”

**Sam:** “Yeah. When we first started into business more than 20 years ago, we were a partnership. An insurance guy sold us some policies that either of us could use to buy out the other if someone died.”

**Pete:** “I didn’t know that part of your company’s history. Why did you change the agreement?”

**Sam:** “When we incorporated we had the company purchase the stock instead of us individually. The accountant said it was usually easier to make insurance payments with company-owned policies. He also said that it would be better if we ever added new shareholders.”

Sam’s business has an entity purchase agreement. As the number of owners grows, cross-purchase agreements can become unwieldy. By the time that businesses reach \$3 to \$5 million in value or more and have more than a couple of owners, their buy-sell agreements tend to be entity purchase agreements.

Sometimes, agreements provide that the other owners will have an opportunity to acquire shares that are being sold through the operation of a buy-sell agreement. In those cases, there may be guidance regarding which shareholders can buy in what order, or that all shareholders can participate in the transaction pro rata to their ownership. Usually there are rules to prevent any possible change of control through such purchases. In any event, the company normally has a last look and obligation to purchase shares if the shareholders don’t. Things can get complicated.

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**Pete:** “There are three main ways that prices are set for buy-sell agreements. There are agreements with fixed prices. Other agreements have formulas to determine the price. And finally, many agreements call for business appraisers to set the price in a valuation process. How is the price set in your agreement?”

**Sam:** “Well, when we signed our agreement 14 years ago, we agreed to set the value of the business at \$4 million, so I guess we have a fixed-price agreement.”

**Pete:** “Did you agree on that price formally as part of the buy-sell agreement?”

**Sam:** “Yes, we both signed off on that value and made it an exhibit to the agreement.”

**Pete:** “Then you definitely have what is called a fixed-price agreement.”

Based on more than thirty years of experience, I know that most fixed-price agreements are not updated by the owners on any regular basis. Over time the interests in various parties can diverge for reasons of age, health, or attitude. But dated prices in agreements can be disastrous. Read on...

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**Pete:** “So you set the value of the business at \$4 million when you set up your buy-sell agreement. Have you changed the price in the agreement since then?”

**Sam:** “Sure. When William and Don came on board 10 years ago, we reset the price to value the company at \$6 million. We updated that exhibit to the agreement at that time.”

**Pete:** “And how about since then?”

**Sam:** “Ouch! We have not.”

**Pete:** “And what do you think the value of the business is today?”

**Sam:** “I don’t know for sure, but we have tripled sales and earnings have grown even more since those younger guys joined us. I’d guess the business is worth \$20 million, give or take a bit.”

**Pete:** “What would happen if you were to die tomorrow?”

**Sam:** “The company could buy my stock for \$2.4 million, or my 40% times the \$6 million price in the agreement.”

**Pete:** “And, it is worth ...?”

**Sam:** “Maybe \$8 million. I’m beginning to see what you’re talking about.”

**Pete:** “Some people think that a formula is the way to go to set the price for a buy-sell agreement. Did you guys ever consider using a formula to establish the price?”

**Sam:** “We talked about using a formula, but things change so much in our industry that we were concerned that a static formula might not work for us. I’ve seen good companies in our business sell for less than 4 times earnings during recessions and for more than 6 times earnings during better times.”

**Pete:** “So you decided to update the value every year yourselves instead of risking the use of a formula?”

**Sam:** “That’s right. But that strategy hasn’t seemed to work so well for us in retrospect. We had the best of intentions, but we just never seem to get around to resetting the price.”

No formula will consistently establish reasonable pricing given changes in industries, economies, financing and within companies. Now, about fixed price agreements...

Mike, a friend of mine told me this true story. In 1962, his father invested \$250 thousand in a startup business with three friends who put up equal amounts of the initial investment. The partners worked well together and the business grew and became profitable. By 1974, the business was worth perhaps \$5 million. Mike is an appraiser, so his estimate is probably close.

Unfortunately, his father died unexpectedly in 1974. Now the partners had signed a buy-sell agreement back in 1962. Guess what the fixed-price agreement said Mike’s father’s shares were worth? You guessed it -- \$250 thousand. Despite his mother’s efforts on the part of the estate, the remaining three partners stuck to the letter of the 1962 agreement and paid \$250 thousand for the shares.

Mike told me that the difference between receiving \$250 thousand and \$1.25 million, or his father’s share of the 1974 value of the business, made a difference in his mother’s financial independence for the rest of her life. It also left her bitter and with a strong sense of resentment for her father’s former friends.

Fixed price buy-sell agreements can be dangerous!

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**Pete:** “Have you ever heard of a shotgun agreement for setting price for buy-sell agreements?”

**Sam:** “Yes. Our attorney suggested we try that when we first got started.”

**Pete:** “Why didn’t you do it?”

**Sam:** “Well, I talked that over with my wife and she said ‘No way!’ She didn’t want either end of a shotgun if something happened to me.”

**Pete:** “That shows a lot of insight on her part.”

**Sam:** “I’ve always said she’s the brains of our partnership.”

Shotgun agreements may sometimes work if two equal partners want to provide for a way to disentangle in the event of irresolvable disagreements between them. If both have financial capacity and are knowledgeable about a business, then a shotgun mechanism

can work. However, if the partners are unequal, the shotgun mechanism tends to favor the partner with more stock. And, as Sam's wife so wisely observed, shotguns can be disastrous if one partner dies and the other's estate has to deal from a point of weakness with the remaining partner.

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**Pete:** By the way, does your buy-sell agreement have a right of first refusal in it?"

**Sam:** "I don't think so. When it was just George and me, we didn't think we'd need something like that. I remember that it offended George that I might even consider such a thing. I do remember that our accountant suggested we add a right of first refusal to our buy-sell agreement when William and Don joined us, but we never got around to it."

A right of first refusal gives remaining owners the right to purchase the shares of another who may attempt to sell to outside parties. Typically, these rights provide for the remaining owners and/or the company to be able to purchase the offered shares for the same price and on the same terms as offered by an outside party. And they keep the stock within friendly hands. Most buy-sell agreements contain right of first refusal provisions.

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**Pete:** "Let's keep on. We're learning a lot about your buy-sell agreement. And we're learning that it does have some problems. Stay with me a while longer and we'll get you in a position to begin to get your agreement fixed."

**Pete:** "Have you ever heard of a buy-sell agreement where there is an appraisal process to establish the price?"

**Sam:** "Yes. A number of my friends have mentioned that their agreements work that way."

**Pete:** "Did you guys ever consider a valuation process for your agreement?"

**Sam:** "Not really. But, wait! When we told our attorney that we were going to set the price for our agreement, he asked us what we would do if we hadn't agreed on an updated price and the fixed-price was way out of date. We said we didn't know. So he put a paragraph in the agreement to fix that problem."

**Pete:** "What do you mean?"

**Sam:** "Well, there's a paragraph in the agreement somewhere that says something about us hiring appraisers if the price in the agreements is more than two years old and, as you say, the agreement is "triggered" for some reason. Maybe I'd get a better value than the \$6 million fixed price after all."

**Pete:** “Do you know how that process would work?”

**Sam:** “Actually, I don’t have a clue.

In this Kindle book, we will spend a great deal of time talking about valuation processes for determining the price for buy-sell agreements. It is important that the processes be spelled out clearly in every agreement. What I know is that it is virtually impossible to specify a workable valuation process in a short paragraph as found in Sam’s agreement – and for many other agreements.

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**Pete:** “That brings us to a critical point in our discussion. I told you at dinner the other night that I knew your buy-sell agreement had problems. You didn’t believe me, did you?”

**Sam:** “Well, I had a vague suspicion about a few things, particularly, about not having updated the price in the agreement. But no, I didn’t really believe you.”

**Pete:** “Do you believe me now?”

**Sam:** “Yup, I do. I know that the fixed-price deal is not working. We don’t have a right of first refusal; so basically, anyone can do pretty much what they please with the stock, regardless of what the rest of us think. I don’t have the foggiest idea of what happens if someone gets divorced, and William is not in a good family situation right now. If something happens now, the price might be set by some appraisers, and we don’t know who they are or what the process is or what kind of value they might reach. Other than that, I guess, our agreement is in pretty good shape!”

**Pete:** “Don’t be hard on yourself. As they say, forewarned is forearmed. I can’t tell you how many buy-sell agreements have the same problems and many more. The bottom line is that we tend to avoid thinking about them because we don’t like to think about unpleasant things. And many owners, like you and George, avoid talking about their agreements like they are the plague.”

**Sam:** “That pretty much describes our situation.”

I make the point many times in this book that it is essential for the owners to get together to reach agreement on critical buy-sell agreement issues. Sam is well on his way to being convinced to take action.

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**Pete:** “Let’s focus on one other thing now. If a shareholder dies and there isn’t enough life insurance to purchase the stock at a trigger event, what happens?”

**Sam:** “The company will issue a note for the balance.”

**Pete:** “What are the terms of the note?”

**Sam:** “Well, let’s see. The company has to pay 20% of the price at closing, and then the rest is paid out over 10 years.”

**Pete:** “What’s the interest rate?”

**Sam:** “Well, it says the note will pay interest at the prime rate of our local bank or its successor.”

**Pete:** “Is that fixed at the time the note is created or does the rate float?”

**Sam:** “It doesn’t say.”

**Pete:** “Could that make a difference to the company or to a shareholder or his estate?”

**Sam:** “You bet it could.”

**Pete:** “And what security does a note holder have?”

**Sam:** “Well, Pete, once again, it doesn’t say.”

**Pete:** “So that means none. Right?”

**Sam:** “I guess so. We do have a lot to work on.”

Unfortunately, the note in Sam’s buy-sell agreement is typical of the promissory notes in many other agreements. Owners work hard to agree on a mechanism to determine price, say fair market value, for shares transferring through buy-sell agreements. However, if their agreement calls for the issuance of a below-market interest rate, an absence of security, and no provisions in the event that the company defaults on a note, then the seller will get less than fair market value for the shares. Why? Because the note received would be valued at less than its face amount.

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**Pete:** “Does the company own any life insurance policies on the lives of the owners?”

**Sam:** “Well, George and I got policies back when William and Don joined us. Let’s see. The value of the company we set was \$4 million, so we got policies for \$2 million each.”

**Pete:** “That was a long time ago. Have you revisited the life insurance question since then?”

**Sam:** “We talked about it when William and Don became owners. I think we reset the value to \$6 million at that time. But we never got around to doing anything about it.”

**Pete:** “Let’s see. The company has policies on you and George for \$2 million each and your interests are likely worth about \$7 or \$8 million each. And William and Don, with 10% of the stock each, have interests worth close to \$2 million each.”

**Sam:** “Wow! It looks like we really need to look into the life insurance question again.”

**Pete:** “Does your buy-sell agreement mention what happens to life insurance proceeds in the event someone dies?”

**Sam:** “No. I’ve been through it a couple of times since we’ve been talking. Not a word.”

Unfortunately, too many buy-sell agreements have associated life insurance and these agreements are silent or confusing regarding the purpose of insurance proceeds. Life insurance can have dramatically different effects for one or both parties depending on how the proceeds are handled. If proceeds are considered to be a corporate asset, and added to value and, therefore, included in price, we get one result. If the proceeds are considered to be a separate funding vehicle and are not included in value, we get another.

For seemingly simple documents, buy-sell agreements have a number of moving parts. In this discussion, Pete has led Sam through his company’s agreement and focused his attention on some glaring issues. If Pete is to be an effective consultant, he needs to present a solution for Sam’s problems. So he does.

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**Pete:** “Sam, I think it is time to talk about the kind of buy-sell agreement that I think is most appropriate for you.”

**Sam:** “After learning what’s wrong with our agreement, I agree!”

**Pete:** “Right now, you have a fixed-price agreement with a dated price. Your agreement also has a multiple appraiser process that will likely not work. The solution is to get together with your fellow owners and to agree on a new buy-sell agreement. What I recommend is a *Single Appraiser, Select Now and Value Now*.”

**Sam:** “What do you mean by that?”

**Pete:** “Let me outline the process for you:

Select a qualified independent business appraiser. You, George, William, and Don get together and work at this a bit. Obtain qualifications information. Ask for references. Talk to the most qualified persons. You should be able to agree on an appraiser.

Have the appraiser provide a draft valuation. The appraiser will ask you what standard of value and level of value the company wants for the agreement. My recommendation is that you tell him or her that fair market value is the standard of value, and that financial control be considered as the appropriate level of value.

Review the draft. Once you have the draft appraisal, all of you should read the draft and go over any questions you have with the appraiser. If you don't understand something, as I often say, 'Don't stand for it.' Just get comfortable with the methodology and the conclusion.

Talk about other terms. We've talked about a number of things you might want to consider when you review your agreement. You can use my *Buy-Sell Agreement Review Checklist* as a guide.

Involve your attorney, who will need to help in revising your buy-sell agreement.

Have your attorney redraft your buy-sell agreement. The new agreement will name the appraiser and the basic qualifications you agreed upon in the selection process. When the appraiser finalizes the appraisal, the conclusion will become the initial price for your new agreement.

Finally, obtain annual or periodic reappraisals. The agreement should call for an annual reappraisal, which should be part of the appraiser's engagement letter with the company. The annual reappraisals will become the new, updated prices for your agreement when they are finalized each year (or every other year at the least)."

**Sam:** "Wow! That's a lot to absorb so quickly."

**Pete:** "It really isn't so bad if you break it down into pieces and work on it. But it really is worth the effort."

**Sam:** "I'm beginning to believe you."

Pete has just outlined the valuation process that is the key recommendation of this book for most successful closely held and family businesses. It is the *Single Appraiser, Select Now and Value Now* process that will be explained in more depth in Chapter 11. I will elaborate on the advantages of this process over all others in most situations and explain the whys of the recommendation. I make this recommendation for your consideration because I know it works and have seen it work in dozens of companies over many years.

I hope you will consider this process as the pricing mechanism for your company's buy-sell agreement.

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**Pete:** "Well, Sam, we've covered a lot of ground in the last few hours."

**Sam:** "We sure have. I didn't have any idea there were so many moving parts to a good buy-sell agreement."

**Pete:** "Right. Let's recap what we've learned about your buy-sell. I do this in the most positive sense, because problems or issues identified can be addressed."

**Sam:** "Let's hear my action list."

**Pete:** "We've learned the following, at least:

Your buy-sell agreement is a fixed-price agreement that was last looked at about 10 years ago.

The price, or value, of the company in your agreement is \$6 million, which was set 10 years ago. But your business is worth maybe \$20 million.

There's a paragraph in your agreement that describes a process to update the price. But my quick review informs us that the paragraph does not address all the elements we've learned about.

The agreement does not address what happens if a shareholder gets divorced, and you indicated this could be an issue in the future.

The company has life insurance of \$2 million on our life and on George's, but that falls far short of the value of your interests of \$7 or \$8 million.

There's no life insurance on the lives of William and Don, and their 10% interests are worth something close to \$2 million each.

The note the company would issue if it had to buy stock from any of the owners is completely unsecured. That's favorable for the company but risky for any selling stockholder. And, the interest rate isn't clearly specified, so there could be confusion there."

**Sam:** "Other than that, Mrs. Lincoln, how was the play?"

**Pete:** "As I've said before, these issues are not uncommon. And they can be fixed, either in a revision or rewrite of your buy-sell agreement."

**Sam:** "How do we get started?"

**Pete:** “For starters, begin talking to each other. I’d recommend that you ask George, William, and Don to read this Kindle book. They can buy it on Amazon.com. Be sure to get your key advisors involved. You will be surprised at the perspectives they can provide if you ask them about the issues raised in this book. Once you’ve agreed on the business points of your buy-sell agreement, your attorney can draft the agreement you need. But you’ll all have to read it and give the attorney your feedback to get the agreement finalized.”

**Sam:** “I’m pretty excited to get this process underway. We do have a bomb in our company yard – our buy-sell agreement! It is past time to get rid of it and to install an agreement that will work reasonably for all of us if something happens in the future.”

**Pete:** “Good luck! Be sure to have your key professionals read the agreement and give their comments. Once you change the agreement, it will likely be in place for a long time, so it is worth the investment to gain their perspectives. Above all, have your business appraiser read all of the language pertaining to the valuation process. That language will be tested in the first appraisal. You can fix it if there’s an issue. Then you will all know it will work going forward, and the appraisal firm will appreciate being written into the agreement.”

**Sam:** “Sounds like a lot of work.”

**Pete:** “Well, it does involve some work. What I can tell you is, regardless of the effort now, it will be easier, more productive, and more enjoyable than attempting to resolve the mess you would have if your current agreement is triggered. You can know your buy-sell agreement will work without triggering it.”

**Sam:** “Wish us luck! And let’s set a meeting with George, William, Don and our company’s attorney.”

**Pete:** “Great! I’m pretty flexible early next week.”

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Thus ends the story of Pete and Sam, two baby boomer business owners. I hope you have found it interesting and that some elements of the story will motivate you to begin a conscious process of examining and updating your company’s buy-sell agreement. You will be glad you did.

Things happen and buy-sell agreements are triggered. Most don’t operate to provide reasonable resolutions. So get rid of your ticking time bomb with the help of your fellow owners and your team of professional advisors. It will be well worth the investment of time and money.

