How to Know Your Agreement Will Work
Without Triggering It

BUY-SELL AGREEMENTS
for Closely Held and Family Business Owners

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PART II: BUY-SELL AGREEMENT ESSENTIALS

Preface

Every successful closely held or family-owned business with two or more owners has a buy-sell agreement – and if it doesn't, it should.

Buy-sell agreements govern how ownership will change hands if and when something significant, often 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 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 or otherwise assuring financing (or life insurance or cash) is available to acquire shares in the event an owner departs.

Unfortunately, based on my experience working with closely held and family businesses for more than 30 years, most buy-sell agreements won't accomplish their objectives in an orderly and reasonable fashion. My first book on the subject, *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?* (2007) addressed the problem primarily from the viewpoint of business advisors.

This book was based on reading many buy-sell agreements, since most of the companies I have valued have or had buy-sell agreements. I have been involved with many buy-sell agreements following trigger events. Trigger events, as we will see, are those (mostly) bad things that cause buy-sell agreements to be put into operation, including death, disability, firings, and numerous others.

We will talk in this book about 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. And I have 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 Mercer Capital and at other companies where I have been an investor.

This book, *Buy-Sell Agreements for Closely Held and Family Business Owners: How to Know Your Agreement Will Work Without Triggering It*, is written for all business owners who have or will have buy-sell agreements for their companies. I have seen enough explosions following the triggering of buy-sell agreements to know that badly crafted agreements can be disastrous for all involved. However, you can know in advance your buy-sell agreement will work – and it doesn't have to be triggered to find out. This book explains how.

Understand the Dangers of Your Current Agreement

Buy-sell agreements have three basic types of pricing mechanisms.

Fixed-price agreements. You and the other owners agree on a price and set that price in the agreement.

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?

Formula agreements. You and the other owners agree on a formula to calculate the price.

FORMULA PRICE 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?

Valuation process agreements. 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.

VALUATION PROCESS 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.

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).

A Word to the Wise

The bottom line 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.

Buy-Sell Agreements for Closely Held and Family Business Owners is written so you can prevent your flawed agreement from exploding and harming you, your fellow owners, all of your families, and even the company itself – and you can do this without triggering the agreement.

How to Read this Book

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.

I recommend that you read this book aggressively.

- Highlight relevant facts or issues for further study.
- Raise questions or make comments in the margins 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 Audit Checklist*, written for use with this book, is available for you to download at

www.buysellagreementsonline.com. Order the checklist, which sells for $19.95, and enter the discount code "FREE" to download the checklist at no cost.

- 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 Audit Checklist* before discussing them with legal counsel or other business advisors. If they are participating in the process with you, work through the checklist together.
- Share the book with your fellow shareholders and use the outline and the *Buy-Sell Agreement Audit Checklist* to facilitate the discussion.
- Have a valuation professional read your buy-sell agreement from valuation and business perspectives and 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 to the future transactions it contemplates? The problem is up to you to resolve.

Chapter Seventeen

The Recommended Structure: Single Appraiser, Select Now and Value Now

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* process."**
Sam:	"What do you mean by that?"
Pete:	**"Let me outline the process for you:**

1. **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.**

2. **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.**

3. **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. You should all be sure that the level of value and financial control is what you want in your agreement.**

4. **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 the *Buy-Sell Agreement Audit Checklist* as a guide.**

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

6. **Have the 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.**

7. **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."

Single Appraiser, Select Now and Value Now

The *Single Appraiser, Select Now and Value Now* buy-sell agreement valuation process is the one I recommend for most successful closely held and family businesses. For the reasons we have discussed at length, I prefer this single appraiser process as the best available alternative for fixed-price, formula, and multiple appraiser agreements.

This chapter mentions two other single appraiser processes:

- *Single Appraiser, Select and Value at Trigger Event*
- *Single Appraiser, Select Now and Value at Trigger Event*

Our focus is on the *Single Appraiser, Select Now and Value Now* process. The other two processes are mentioned because I have seen them in agreements. As we will see, in either of these alternatives, either the initial valuation or both the initial valuation and selection of appraiser are postponed into the indefinite future – i.e., until a trigger event occurs. This postponement of the appraiser selection and initial valuation create substantial uncertainties and potential for disagreement or dispute. In my opinion, these two other single appraiser processes are not ideal substitutes for fixed-price, formula or multiple appraiser process agreements.

In the *Single Appraiser, Select Now and Value Now*, the appraiser is not only named in the agreement, but he or she is engaged to provide an initial appraisal for purposes of the agreement.

- **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.

The *Single Appraiser, Select Now and Value Now* process provides several distinct advantages relative to other process agreements, including:

- The structure and process, in addition to being defined in the agreement, will be known to all parties to the agreement in advance.
- The selected appraiser will be viewed as independent with respect to the process; otherwise, he or she would not have been named. At the very least, the suspicion of bias is minimized.

- The appraiser's valuation approaches and methodologies are seen first hand by the parties before any triggering event occurs.
- The appraiser's valuation conclusion is known at the outset of the agreement by all parties and becomes the agreement's price until the next appraisal, or until a trigger event between recurring appraisals occurs.
- The process is observed at the outset; therefore, all parties know what will happen when a trigger event happens.
- The appraiser must interpret the valuation terms of the agreement in conducting the initial appraisal. Any lack of clarity in the valuation-defining terms ("the words on the pages") will be revealed and can be corrected to the parties' mutual satisfaction.
- Having provided an initial valuation opinion, the appraiser must maintain independence with respect to the process and render future valuations consistent with the instructions in the agreement.
- Because the appraisal process is exercised at least once, or on a recurring basis, it should go smoothly when employed at trigger events and be less time-consuming and less expensive than other alternatives.

One further element can improve the *Single Appraiser, Select Now and Value Now* option even more – regular reappraisals. In my opinion, most companies with substantial value (beginning at $2 to $3 million of value) should have an annual revaluation for their agreements. For most such companies, the cost of the appraisal process is insignificant relative to the certainty provided by maintaining the pricing provisions on a current basis. Owners who view the cost of an annual reappraisal as excessive should have the reappraisals every other year. An overview of the *Single Appraiser, Select Now and Value Now* process is provided in Figure 14.

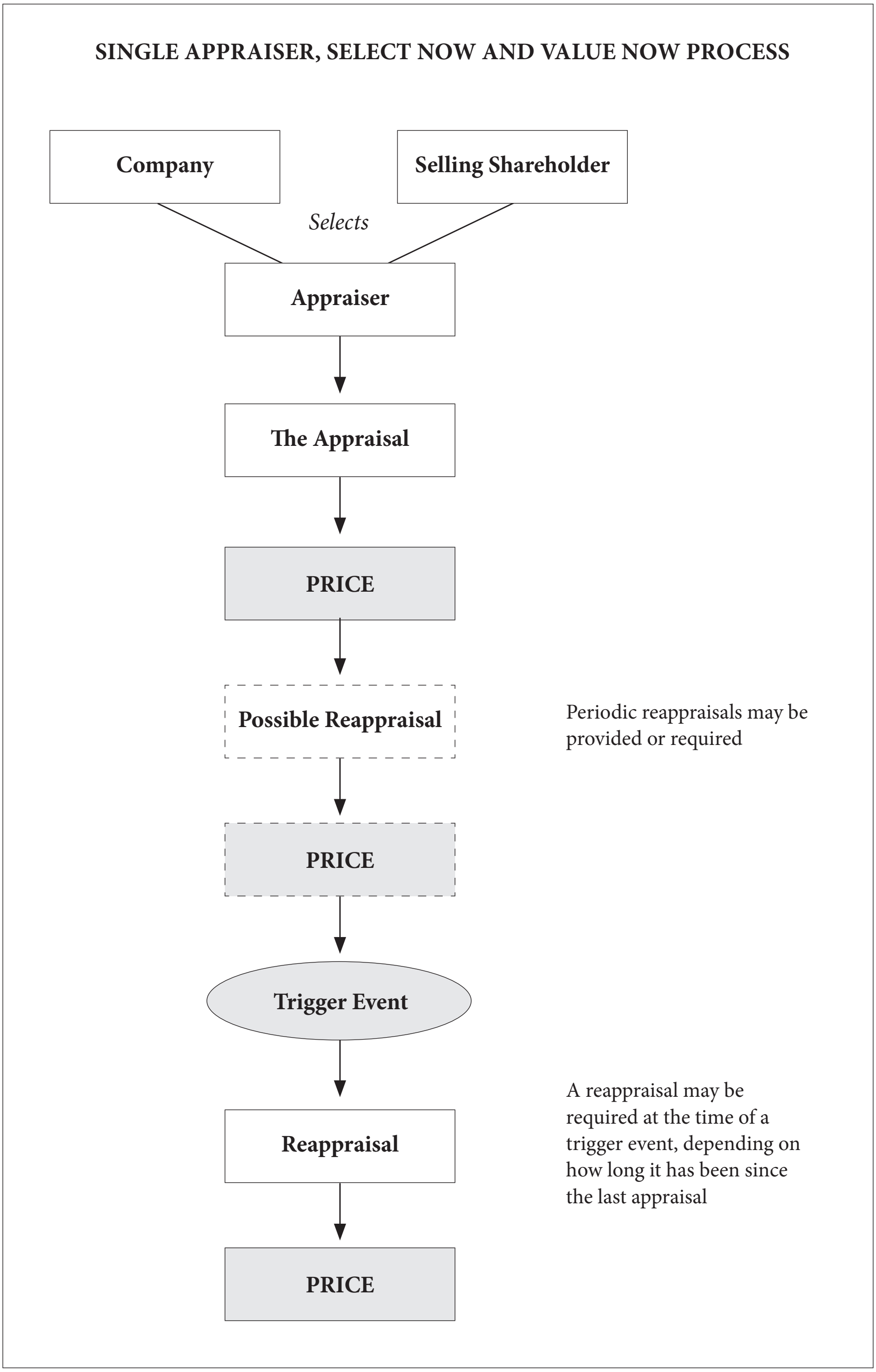
SINGLE APPRAISER, SELECT NOW AND VALUE NOW PROCESS
Company
Selling Shareholder
Selects
Appraiser
The Appraisal
PRICE
Possible Reappraisal
Periodic reappraisals may be provided or required
PRICE
Trigger Event
Reappraisal
A reappraisal may be required at the time of a trigger event, depending on how long it has been since the last appraisal
PRICE

FIGURE 14

Additional benefits from annual or periodic reappraisal for buy-sell agreements include:

- **The parties will tend to gain confidence in the process.** The selected appraisal firm should provide valuations that are generally consistent with prior opinions, taking into account relevant changes in the company, the industry, the economy, and other relevant factors. Subsequent appraisals should be reconciled with prior appraisals so that all parties understand why value has changed.
- **The parties will know the most current value for the buy-sell agreement.** This can be beneficial for a company's planning purposes, for example, facilitating the maintenance of adequate life insurance on the lives of appropriate shareholders. The periodic appraisal will also be helpful for the planning purposes of shareholders.
- **The *Single Appraiser, Select Now and Value Now* process with annual reappraisals facilitates the estate planning objectives of the shareholders at relatively low incremental cost.** If the buy-sell agreement calls for an enterprise level of value (marketable minority or financial control), the appraiser can provide a supplemental appraisal at the nonmarketable minority level for gift and estate tax purposes. This supplemental appraisal would, of course, have to consider the impact of the buy-sell agreement on the value of nonmarketable minority interests. Consult with your tax attorney to be sure that the buy-sell agreement price is determinative of value for estate tax purposes.
- **Enhanced confidence for all parties.** Importantly, because the appraisals are recurring in nature, the appraisal firm's knowledge of a company's business and industry will grow over time, which should further enhance the confidence all parties have in the process and conclusion of value.

In all cases, if the most current appraisal is more than a specified amount of time old, then the agreements should provide for a reappraisal upon the occurrence of a trigger event.

Figure 15 shows the 10 critical disadvantages of multiple appraiser valuation processes relative to their consideration with single appraiser processes. Focus on the disadvantages in the multiple appraisers column and the *Single Appraiser, Select Now and Value Now* column. The middle two columns will come into perspective in the brief discussion of the other two single appraiser processes below.

DISADVANTAGES		MULTIPLE APPRAISER	SINGLE APPRAISER		
			Select and Value at Trigger Event	Select Now and Value at Trigger Event	Select Now and Value Now
1.	Price not determined now	x	x	x	
2.	Potential for dissatisfaction with the process for all parties	x	x	x	Minimized
3.	Danger of advocacy	x	x	Minimized	Minimized
4.	Uncertainty over what will happen when a trigger event occurs	x	x	x	Minimized
5.	Uncertainty over final price if the process is invoked	x	x	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	x	x	Minimized
7.	Expensive	x			
8.	Time-consuming	x			
9.	Distracting for management	x			
10.	Potentially devastating for affected shareholders and their families	x			

FIGURE 15

1. **Price is not determined now.** The *Single Appraiser, Select Now and Value Now* is the only valuation process that provides information about the buy-sell agreement price now. Current information enables the parties to plan and eliminates the great uncertainty about value that builds with the passage of time.

2. **Potential for dissatisfaction with the process for all parties.** There will always be potential for dissatisfaction. Buyers naturally want lower prices and sellers want higher prices. However, if the process works as it should, all parties are much more likely to believe that the prices created by the buy-sell process are reasonable. The *Single Appraiser, Select Now and Value Now* process minimizes this uncertainty.

3. **Danger (or perception) of advocacy.** At the outset, it is possible that one or more parties might believe that the selected single appraiser in a *Single Appraiser, Select Now and Value Now* process could be biased. Such perceptions would likely be minimized or mitigated over time as the appraiser provides subsequent appraisals that can be reconciled with changes in the company, the industry, the economy, and other broad factors. Also, all parties should become more comfortable with the process.

4. **Uncertainty over what will happen when a trigger event occurs.** With a single appraiser who is selected in advance and who provides recurring reappraisals, there should be little, if any, uncertainty about the process that will be invoked when trigger events occur. The process is seen on a recurring basis by all parties. This advantage is minimized or even eliminated by the *Single Appraiser, Select Now and Value Now* process.

5. **Uncertainty over the final price if the process is invoked.** Given that there is a baseline appraisal and the potential for

reappraisals over time with the *Single Appraiser, Select Now and Value Now* process, much of the uncertainty regarding the price at a triggering event should be eliminated. The price should be reasonably consistent with changes in the company's earnings, industry multiples, and other factors familiar to the parties, assuming that the selected appraiser continues to provide appraisals on a consistent basis.

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.** Clearly, any issues with the valuation process would be identified and fixed at the outset or along the way. The process should be clear and well-understood, so issues of this nature should be minimized or eliminated using a *Single Appraiser, Select Now and Value Now* valuation process.

7. **Expensive.** Multiple appraiser processes, with two or three appraisers, multiple sets of lawyers, and occasionally other professionals, as well, can be quite expensive. When, as often happens, these processes become contentious, they become enormously expensive. The *Single Appraiser, Select Now and Value Now* process virtually eliminates the potential for cost expansion. Recurring reappraisals are normally less expensive than the initial appraisal, and since all parties know what will happen at a trigger event, there is little need for excessive legal or appraisal intervention with the process.

8. **Time-consuming.** A reappraisal would be conducted in the normal course of business following a trigger event in the *Single Appraiser, Select Now and Value Now* process. It stands to reason that this process would be of shorter duration than a multiple appraiser process being initiated for the first time under adverse circumstances.

9. **Distracting for management.** As with the prior disadvantage, it should be apparent that a reappraisal conducted in the normal course of business would be less distracting to management than a (likely) contentious valuation process being initiated for the first time.

10. **Potentially devastating for affected shareholders and their families.** With the *Single Appraiser, Select Now and Value Now* process, all shareholders know, in advance, what the valuation process will be like. They also know, at least generally, the range in which the valuation conclusion will occur because of knowledge of prior appraisals and current company performance.

In summary, the *Single Appraiser, Select Now and Value Now* process eliminates the first disadvantage of multiple appraiser processes, because value is known now. It minimizes (or eliminates) uncertainties associated with the next five disadvantages above. Finally, it should eliminate issues related with the last four disadvantages.

This form of single appraiser process is, based on my experience over some 30 years, the most reasonable valuation process for most closely held and family businesses.

Single Appraiser, Select and Value at Trigger Event

In *Single Appraiser, Select and Value at Trigger Event* agreements, the selection of the single appraiser is called for at the time of a triggering event. The selected appraiser provides the valuation based on his interpretation of the language in the buy-sell agreement. The single appraiser's valuation conclusion then sets the price for purposes of the buy-sell agreement.

The advantages of a single appraiser process are similar to those of the multiple appraiser processes previously outlined.

- It provides a defined structure or process for determining the price at which future transactions will occur.
- All parties to the agreement know in advance, at least generally, what the process will be.
- The cost of the process, if not known precisely in advance, is reasonably definable.
- The general process is fairly commonly known and understood by attorneys. The single appraiser process is simpler than multiple appraiser processes since only one appraiser must be selected.
- Parties to single appraiser agreements should believe they are protected by the process since they will have a voice in the selection of the appraiser. All sides have a role to ensure that an independent appraiser is selected, i.e., one who will provide a balanced analysis and a "fair" valuation rendered in accordance with the agreed upon defining elements and taking into account the interests of both sides during the appraisal process.

The company (its CEO or CFO) may be the primary driver in the process of selecting the appraiser. It is therefore important that each party subject to the agreement has an active role in the selection process (probably veto power). This is why it is essential to specify the qualifications of the appraiser in advance. The pool of potential appraisers should include only those that obviously meet the stated qualifications. Both sides must have input and agree, or there can definitely be a perception of bias, at least initially.

There are, however, disadvantages specific to the *Single Appraiser, Select and Value at Trigger Event* process as shown in Figure 15.

There is an additional disadvantage of the *Select and Value at Trigger Event* variation. Once a trigger event occurs, the interests of the parties diverge. It is possible that they will be unable to agree on the selection of an appraiser.

Therefore, it is necessary to have an alternate appraiser selection process, perhaps through mediation or arbitration, to select the appraiser. Processes that begin in this fashion have a higher probability of problems than when the parties reach agreement before a triggering event.

Nevertheless, on balance, the *Select and Value at Trigger Event* process eliminates a number of the disadvantages of multiple appraiser agreements. These processes are less time consuming and less expensive. They should therefore be less distracting for management. And they have the potential to be less worrisome for families of deceased (or otherwise departed) owners.

Single Appraiser, Select Now and Value at Trigger Event

The third single appraiser process is *Select Now and Value at Trigger Event*. The appraiser is named in the agreement and will be called upon to provide the required appraisals at the time of future trigger events. At the time the agreement is created (or an older agreement is revised), the parties may discuss potential appraisers (appraisal firms), interview one or more firms, and select a mutually agreeable appraiser/firm. This firm is written into the agreement as the named appraiser.

The *Select Now and Value at Trigger Event* form of agreement eliminates the future uncertainty of selecting an appraiser, which is an improvement over *Select and Value at Trigger Event* agreements, but the other uncertainties and disadvantages remain. However, concerns over the degree of perceived appraiser advocacy should be minimized since the parties have time to agree on the selected appraiser absent the pressure of a trigger event.

SINGLE APPRAISER, SELECT NOW AND VALUE NOW (AND ANNUALLY THEREAFTER)

I've been advancing the idea of the *Single Appraiser, Select Now and Value Now* process because I know it works. Consider the following:

- There are some 10,000 private companies in the U.S. that have Employee Stock Ownership Plans (ESOPs). Every one of these companies has an appraisal at least annually. In my experience, the buy-sell agreements of most ESOP companies are tied to the annual appraisals and most transactions that occur in the stock of these companies are at their most recent appraised prices.
- Some 20 of my long-standing client companies have had annual appraisals for many years. Their buy-sell agreements and the estate planning of their owners are tied to these annual reappraisals. Many of these companies do not have ESOPs, so they obtain their appraisals voluntarily on the basis of their direct and indirect benefits for the companies and their owners.
- Closer to home, my company, Mercer Capital, is an ESOP company, and we obtain an independent appraisal each year. Our buy-sell agreement is tied to this annual appraisal.
- One client company of 20 years has purchased more than $100 million of stock from employees over the last six years and has sold more than $30 million of stock to employees on the basis of annual appraisals.

I advocate the *Single Appraiser, Select Now and Value Now* process for most buy-sell agreements because it is the only one that will ensure that your buy-sell agreement will work when it is triggered.