

Don't Rely Upon Templates When Constructing Buy-Sell Agreements

This short article is a warning against the blind use of legal forms, or templates, for developing buy-sell agreements. Parties to each and every buy-sell agreement need to take time to agree on the key business and valuation aspects of their agreements, then have a qualified attorney (who can also be involved in reaching agreement) draw up the document.

What could be simpler? All the parties have to do is to agree on the events that “trigger” the buy-sell agreement, on who buys stock, and on the pricing and terms of the purchase. Also, it is helpful if the funding for the transaction is specified, as well. The problem is, if my experience is any indication, these things are almost never agreed to at the level at which it is necessary for the shareholders to understand what will happen when their buy-sell agreements are triggered by the quitting, firing, retiring, death, disability, divorce, etc. of a shareholder.

Keep in mind that I am not a lawyer and do not draft buy-sell agreements. I am, however, a business appraiser who has seen hundreds of buy-sell agreements as part of our normal valuation practice – too many of which after failed valuation processes when litigation has already ensued. As such, I read and interpret buy-sell agreements *from business and valuation perspectives* in the normal course of my business and I can say that relatively few of them address the basic questions in unambiguous terms. Could this be because, in part, too many people rely upon standard forms rather than doing the sometimes difficult work of sitting down together to agree to the key business and valuation issues?

Over the New Year holidays, I did some fairly unscientific research. I googled the terms “buy-sell agreements” and “buy-sell agreement forms.” In searching quite deep into the rankings, six forms were found that were available on-line and free. There are numerous sites that charge for buy-sell agreement forms, and others that claim to offer templates “for free,” but require a “membership” to access them. At another time, I’ll set a budget and go form-shopping to see if the results are different. Of the six free templates found, I noted the following:

1. *A cross-purchase agreement.* One was a cross-purchase agreement template calling for each of two shareholders to purchase life insurance on the life of the other. They had to agree on value periodically. Did I say that shareholders almost *never* do this? There was no other pricing mechanism.
2. *A (valuation) process agreement.* This template addressed only death and termination of employment and no other trigger events (e.g., divorce or disability). The pricing mechanism read as follows:

“Unless the parties agree to another price in writing, the price for each share of capital stock shall be equal to its fair market value as an ongoing business concern as determined in the sole discretion of the company’s Certified Public Accountant (CPA), and such determination shall be binding and conclusive upon the parties hereto.”

“Fair market value” is generally thought to be a defined term among business appraisers, but what if the company’s CPA is not an appraiser? The definition above leaves open to the sole discretion of the CPA, who may not be qualified as an appraiser, as to whether valuation discounts, such as minority interest or marketability discounts, should be considered and/or applied in the determination of price. Would you want an unqualified CPA making such decisions? Would he or she want to make them?

This agreement also had a deadlock provision in the event that the parties could not agree on the company's CPA. In that event, the shareholder's estate and the company would each select a CPA, the two of which would select a third CPA. The price would be the average of the three conclusions. Note that there is no requirement that the other CPAs be business appraisers or have appraisal credentials.

It was not clear whether the life insurance the company might purchase (at its election) should be considered to be a corporate asset (and added to value in the determination of price) or as a funding mechanism only, and not added to value. The CPA would, in his or her sole discretion, have to make that decision.

This agreement, if implemented, would be a disaster waiting to happen.

An identical form was found on another website.

3. *A corporate buy-sell agreement.* This agreement template suggested either an agreed value, or a formula value, but only blanks for the formula were provided. The most likely valuation mechanism was then defined:

“Purchase Price in Lieu of Establishment of Current Agreed Value. In the event the Shareholders do not establish an Agreed Value for more than two (2) years prior to the Date of Death or Withdrawal or Date of Occurrence, then the Agreed Value shall be calculated by an independent Certified Public Accountant acceptable to a majority of the shareholders. The accountant shall determine the fair market value of the Stock as of the Date of Death or Withdrawal or Date of Occurrence, as appropriate, by whatever means he deems appropriate. This fair market value shall then become the Agreed Value. The accountant may apply *whatever discounts he believes appropriate*, including discounts for lack of marketability. The fees and expenses of the accountant shall be paid by the Company.” (*emphasis added*)

Should the CPA have appraisal credentials? Is the appropriate “fair market value” that of the entire company or of just the interest in the company subject to the agreement? Note that a minority shareholder subject to the agreement might have no say whatsoever in the selection of the CPA, since the selection will be determined by a majority of the shareholders by number. If there are at least three shareholders, this situation could easily occur.

4. *A right of first refusal.* Another agreement template entitled “Buy-Sell Agreement Between Stockholders” was nothing more than an onerous right of first refusal and was not a buy-sell agreement at all.
5. *A public company voting trust.* The last free buy-sell agreement template found involved the creation of a voting trust of a presumably public company. The pricing for transactions pursuant to the agreement was the average of the opening and closing prices on the specified notification date. There were voting and nonvoting shares. The agreement did specify that there would be no differential in pricing between the two types of shares.

There's an old saying: “There's no such thing as a free lunch.” My search for buy-sell agreement template language would suggest that there's no such thing as a free and workable buy-sell agreement form. Perhaps the forms that carry a price are better. Those ranged from \$2.99 to \$79.00. Given this pricing, keep in mind another saying: “You pays your money and you takes your chances.”

There's no substitute for shareholders sitting down in an organized fashion and working out the business and valuation decisions together. This can be done with the benefit of advice from counsel or other trusted advisors.

In conclusion, if the shareholders agree on the pertinent business and valuation points, any experienced business attorney should be able to reflect that appropriately in the buy-sell agreement. My business and valuation advice is straightforward. Do not blindly use any template when creating a buy-sell agreement. Rather, get agreement on critical issues and then modify whatever form is used to reflect the actual agreement of the parties. And in the likely event that you have a buy-sell agreement and don't know the answers to the basic questions mentioned above, now would be a good time to convene a meeting of the shareholders to consider revising the buy-sell agreement.

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