FINANCE 101

BUY-SELL AGREEMENTS

BUSINESS VALUATIONS

*By Daniel M. Isard*

# Where Do I Go From Here?

The components of a buy-sell agreement, establishing fair market value, valuing shareholders' stock and determining whether the transaction is financeable.

*Dear Dan,*
*Almost 30 years ago, I started to work for a funeral home. About 10 years into my employment, I was given the chance to buy a 25% stake in the business for $100,000. The seller, 10 years older than I am, continued to work with me as the 75% stockholder. I agreed to allow him to deduct $650 per month from my paycheck to finance this purchase over 20 years. His lawyer wrote up a buy-sell agreement I was told was routine and ordinary.*

*Over the past 20 years, nothing has changed within the scope of the buy-sell agreement. Even with the decline in interest rates, I did not request a change. I guess I could have saved the money that I spent on interest expenses; however, we did not change the terms or conditions.*

*Well, I am now writing to ask a question because my partner cannot. He died. I read the buy-sell agreement for the first time since signing it and discovered that the value of the business is a formula. The formula is stated as "the value of the company shall be established by multiplying the revenue of the business, net of cash advances, by one."*

*We are a $1.2 million revenue business, which means the total value is $1.2 million. The deceased owner's 75% interest is worth $900,000. I get that. That is exactly what I remember being discussed.*

*What I don't get is that the lawyer and accountant of the deceased have hired a funeral home appraiser, who has stated the company value at $2.6 million. They contend that I owe his estate 75% of $2.6 million, which is $1.95 million! That is an increase in value of $1.15 million! They even went as far as to contact a lender familiar with funeral service that confirmed it will loan me the $1.95 million.*

*What is a buy-sell agreement for if not to set the value?*

*Signed, 20 Years of Servitude in Seville*

Dear Seville,
Do you know who uttered the phrase, "Never introduce logic into an argument"? I did. I learned that through multiple marriages. You are learning this now through your business marriage. There are four key points you raised in your question:

1. *Is a buy-sell agreement binding?* A buy-sell agreement is a contract that determines the action of the parties in buying and, at the same time, selling a business. Only a judge can determine whether a contract is binding. However, in the purview of the IRS, a buy-sell agreement is binding if:
- The price is set by appraisal or clear formula.
- The agreement has been reviewed.
- The purchase and sale is mandatory, as opposed to optional.

When a buy-sell agreement is written, it has all of the normal contract-speak about it being binding upon the heirs and legatees of the parties to the contract. It can be changed by the mutual consent of all parties. In your case, Seville, one party is dead. Therefore, it not only can't be changed, but it is binding to the heirs.

2. *Are the terms of your buy-sell agreement binding?* Typically, a buy-sell agreement states that the agreement is binding. There are seven possible methods by which the stock would be subject to a change of ownership and therefore governed by the agreement:
- *Third-party solicitation of a shareholder's interest:* In this case, the shareholder must disclose the offer, and the offer has to be a bona fide offer. The receiving party has to give their other shareholder the right to match the price and terms stated.
- *Death of a shareholder:* Upon the death of a shareholder, the survivor(s) purchases or causes the corporation to repurchase the deceased shareholder's ownership.
- *Retirement of a shareholder:* Typically, a shareholder reaches an agreed-upon age, and at that time, the shares are sold as per the agreement.
- *Termination of employment of a shareholder:* If the shareholder elects to stop working for the company, his or her shares would be purchased.
- *Disability of a shareholder:* This is probably the stickiest wicket of all. We know what happens when someone dies or retires, but if someone is disabled, we need a clear definition of the buy-sell agreement. It also may be the most troubling in the continuity of the business if a shareholder is partially disabled but not totally disabled.
- *Shareholder divorce issues:* In this case, the court may rule that the divorcing spouse, who is not active in the business, might be entitled to a portion of the shares. The agreement would typically mandate that the actively employed shareholder buy the shares back at the price set by the agreement or the court.
- *Business divorce:* This happens in 1 out of 100 cases. While infrequent, it is a problem if you are that 1 out of 100! In this case, the shareholders don't like each other and don't trust each other. They want to split up, but it is not certain who should buy whom out.

3. *How do you determine value for a buy-sell agreement?* This is really simple. The value should be fair market value. Fair market value should be established by an appraiser, not

a formula, since there are too many ways in which a formula can be wrong.

Imagine you come up with a formula – say, as you did, one times revenue. Well, 20 years ago when you signed this agreement, values were high and going higher. In 1999, they reached an all-time high and then plummeted. So the value was perhaps accurate in 1995, but by 1998, the formula produced a value that was too low. If you were the seller in 1998, would you have been happy? Of course not. Then, in 2001, as SCI and Stewart were selling places and Loewen and one other were in bankruptcy, that 1995 value might have been too high.

An appraiser proficient in the valuation of funeral homes would know about the market conditions changing. He or she might reach a different conclusion for the same firm if the appraisal were done two years apart.

Also, using just any business appraiser is a waste of money and could lead to ruin. When funeral homes were selling for four times EBITDA, I saw one unqualified appraiser conclude that the value of a business was four times revenue. That was a massive error and led to years of litigation.

Once the fair market value for the whole business is established, we then need to value the block of stock of the shareholders. There are three typical scenarios we see:

• A *majority ownership interest* is when one party has control over the other(s). If a business is valued at $10 and there are 10 shares, you would think each share should be worth $1. However, if one party owns six shares, that party controls the operations of the business should they elect to do so. They can elect the board of directors, which hires the officers. They can control the timing of distributions of profit. You can make the argument that 60% is worth a premium because you have the added benefits. This benefit could be a premium of 15% to 25% if someone wanted to have this control. Of course, upon a liquidation, each share gets an equal distribution of the liquidation.

• A *minority ownership interest,* which is when one party has less than a 50% interest, is just the opposite. The shareholders do not have control of the board and all that comes with it. If someone had four shares in the above scenario, they might be unable to sell their shares in an open market at the prorated value ($1/share). They may have to sell them at a discount. The discounts I have seen and studied can be 25% to 35%, but in some cases, it can be as much as 80%!

• An *equal ownership interest* is when all parties have equal ownership. In this case, there is neither a premium nor a discount to the shares. Having two equal shareholders results in the chance of a deadlock. When there are more shareholders that are equal in ownership, that may or may not be resolved via a deadlock. With three equal shareholders, matters may be resolved by vote in every case, but there are more voices wanting to be heard at the company meetings.

**THE VALUE FOR A BUY-SELL AGREEMENT SHOULD BE FAIR MARKET VALUE. FAIR MARKET VALUE SHOULD BE ESTABLISHED BY AN APPRAISER, NOT A FORMULA, SINCE THERE ARE TOO MANY WAYS IN WHICH A FORMULA CAN BE WRONG.**

4. *Is the funding feasible?* A buy-sell agreement assumes that there is a buyer and a seller. There can only be a buyer if there is money available to fund the agreement. When an appraiser concludes a valuation, the appraiser needs to prove his or her work by showing that the transaction is financeable.

I suspect that this proof might be omitted from the conclusion of your former partner's team of experts. Regardless, be prepared with your own computations.

Seville, if you have a binding agreement, let the agreement speak. If the other side doesn't like what the agreement is saying, I counsel you to hear the words of my boyhood chums on the streets of Philadelphia. The phrase is "tough nuggies." I'm certain the lawyers you'll work with for the next two years can say it in Latin, and opposing counsel will have precedents to quote in their opposition.

Yours is indeed an unfortunate position.

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