Buy-Sell Agreements:

Is There a Storm on the Horizon?

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Many businesses operate under the terms of a buy-sell agreement. Chances are that, as a business owner, you ***should*** have a buy-sell agreement. It is a prudent business practice. The reasons for having a buy-sell agreement include:

- Protecting what is likely your most significant asset.
- Creating a market for a closely held interest.
- Providing a framework for dealing with owner disputes and when other unexpected things happen.
- Forcing shareholders to deal with funding and liquidity issues.
- Allowing shareholders to control who they are in business with.
- Facilitating estate planning objectives.
- Last and certainly not least…providing peace of mind to owners knowing their family will be fairly treated in the event of unexpected circumstances.

But here is the catch…most buy-sell agreements don't work…or won't work as intended. The reasons why they don't work are varied but typically include one or more of the following:

- The agreement becomes dated. Change happens…in life and in your business. Buy-sell agreements rarely keep pace with the changes.
- Valuation language is not clear and leaves room for interpretation; the valuation provision is inappropriate; or the valuation provision is dead wrong!
- Critical elements of the agreement have been overlooked and left out.
- Ownership interests diverge over time, especially when "trigger events" occur.

A buy-sell agreement is usually ratified when a business begins. It is filed away and often forgotten. Over time, the business, its ownership, purpose, and operations can change. The buy-sell agreement is rarely amended to include changes addressing these issues.

The valuation wording in the agreement is important and will be the driving force behind the determination of the value of your business. Rarely is the wording sufficient to provide a clear path to do so. Has the standard of value and level of value been properly defined? Has an effective date been established? Have the qualifications of Appraisers and Appraisal Standards to be followed been defined? Omitting these and other critical elements can leave the agreement "up to interpretation" and a possible outcome unfair to one party. If the agreement contains a formula or other provision to determine the value of your company, has it been reviewed to determine if it is still appropriate…or ever was for that matter?

Have critical elements of the agreement been addressed? Does it contain all of the triggering events that it should? Death is listed in most buy-sell agreements but what happens if a shareholder quits, is fired, retires, divorces, becomes disabled, or files for bankruptcy? These are more likely to happen than death. Does the agreement include a provision for how a purchase is to be funded? The absence of these elements can render an agreement unworkable.

The interests of owners naturally diverge over time, but never more than when a trigger event occurs. You can rest assured that when such an event occurs, one side wants to receive the most money for its ownership interest and the other side wants to pay the least. Ideally, the price paid for an ownership interest will be fair to both parties. Unless the issues identified above are properly addressed, there is a significant risk that the price will not be fair to someone. In light of this, can you know which side of a transaction you will be on? Do you like the thought that your family could receive less for your ownership interest than it otherwise would, just because the buy-sell agreement was not properly vetted? On the flip side, would you like to be the remaining shareholder in a business that is strapped with an obligation to buy out a former shareholder that is too high?

One issue in particular was the subject of a discussion in a LinkedIn group in which I am a member. It centered on a real-life valuation issue faced by a company due to language missing in their buy-sell agreement. It would not have occurred if the buy-sell agreement addressed the critical elements discussed above. The element in question is the funding mechanism and the issue at stake is having clear, concise wording in the buy-sell agreement detailing its treatment.

The situation that was brought up for discussion is very common – a C corporation owns several life insurance policies on its owners. Let's call one of the owners…Fred. Fred dies. When valuing the shares of the Company for Fred's estate tax valuation, how should you treat the life insurance policy proceeds? The buy-sell agreement was silent with respect to the treatment of the life insurance proceeds and was missing a critical element - *the discussion on the funding mechanisms in place*. This raises the following questions:

- Are the life insurance proceeds a non-operating asset of the Company; or…
- Are the life insurance proceeds a funding mechanism and not an asset of the Company?

The answer to these questions could have a drastic impact on the value of any interest in the Company. If the buy-sell agreement does not adequately address this issue it will be left to the interpretation of the valuator. Let's look at an example showing the potential impact.

Assume there are three equal owners of a Company that is worth $9 million. The value of each owner's interest is $3 million. Assume that the Company has life insurance policies in place on each owner for $4 million dollars. The Company is the beneficiary of the policies. One of the owners dies.

If we take the view that ***the proceeds are not a corporate asset*** we begin with the $9 million value ($3 million per owner) add the $4 million proceeds from the insurance policy and subtract the $3 million dollars paid to purchase the stock of the estate of the owner who passed away. The remaining $1 million dollars is retained by the Company, increasing the overall value to $10 million dollars and the two remaining owners are now equal owners with interests valued at $5 million each. The net increase in the value of the Company is $1 million, with each remaining owner's value increased by $2 million.

If we take the view that ***the proceeds are a corporate asset*** we begin with the $9 million value add the $4 million proceeds from the insurance policy for a total value of $13 million ($4.33 million per owner). We then subtract the $4.33 million dollar repurchase liability paid to purchase the stock from the estate of the owner who passed away. The Company would have to borrow the difference between the life insurance proceeds and the value of the estate's stake, or use cash on hand that would otherwise be retained in the business. The result is a decline in the remaining value of the Company to $8.67 million dollars and the two remaining owners are now equal owners with interests valued at $4.33 million each.

The following chart shows the impact.

	Proceeds ***Are Not*** a Corporate Asset	Proceeds ***Are*** a Corporate Asset	Valuation Difference
Pre Life Insurance Value	$9 million	$9 million	
Add: Life Insurance Proceeds	-	$4 million	
Total Value	$9 million	$13 million	
Add: Life Insurance Proceeds	$4 million	-	
Less: Repurchase Liability (Estate)	($3 million)	($4.33 million)	($1.33 million)
Ending Value	$10 million	$8.67 million	$1.33 million
Value to remaining owners	$5 million	$4.33 million	$0.67 million

In the first example, the estate received $3 million dollars and the remaining owners retained interests worth $5 million each. The overall value of the Company increased $1 million.

In the second example the estate received $4.33 million and the remaining owners retained interests worth $4.33 million each. The value of the Company declined $0.33 million.

The net impact of the two situations is a $1.33 million difference in proceeds to the estate or residual value retained by remaining ownership. *Which situation is fair*…less money to the estate, or saddling the Company with more debt when it just lost one of its owners? There is no clear answer. Therein lies the importance of owners understanding their buy-sell agreement and the impact it can have. I believe Fred and his co-owners would have preferred to discuss the impact of the treatment of insurance proceeds and determine what they feel is fair ***prior*** to his death. There would be less stress and uncertainty on all of the parties.

The good news is that it is not too late to fix your buy-sell agreement! This and other issues can be fixed with competent legal counsel and a valuation professional that understands the impact a buy-sell agreement can have on the valuation of a company. I hope that I have motivated you to review your buy-sell agreement and address any areas that lack clarity. Should you have questions regarding your buy-sell agreement please contact me, T. Eric Blocher, CPA, ASA, CVA, Principal with McKonly & Asbury, at eblocher@macpas.com or by calling (717) 972-5730. You can also visit our website at www.macpas.com to learn more about our business valuation services.