CORPORATE VALUE PARTNERS
NEWS
CORPORATE FINANCE INSIGHTS

Spring 2018

Buy-Sell Agreements: Different Flavors

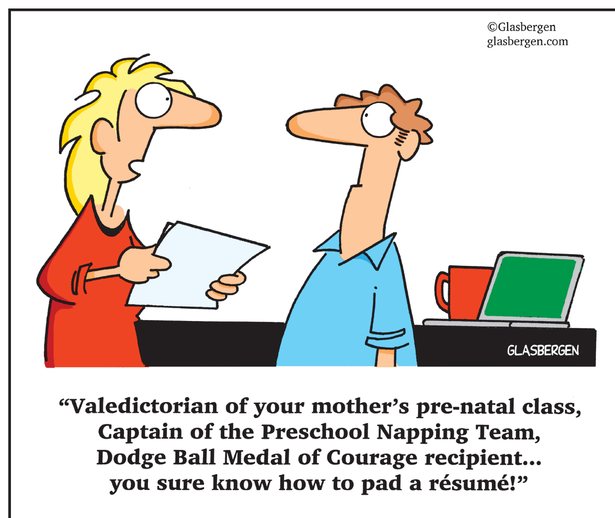
In my last newsletter we went through a general introduction to Buy-Sell agreements. This newsletter continues the introduction but gets a little more specific by describing different types of Buy-Sell agreements. (As I mentioned in my last newsletter, much of the information below can be found in a text written by Z. Christopher Mercer titled, *Buy-Sell Agreements for Closely Held and Family Business Owners.*)

Three Flavors

There are three general types of Buy-Sell agreements. They are often defined as: fixed price, formula price, and valuation process. Fixed price agreements are exactly as they are advertised – the price is set in the agreement, and that price stands until the agreement is updated. Fixed price agreements tend to result in a fairly high percentage of problems because the agreed-upon price is typically not updated regularly, if at all. Also, it is common that there is very little analysis behind the agreed-upon price. It is not unusual with fixed price agreements that the owners would be contemplating a purchase price for shares that was set years ago when the business was very different. Additionally, it is common that there is little to no support for how the owners arrived at the original price.

Formula price agreements include a formula that sets the price of the shares at the date that the Buy-Sell agreement is invoked. A common formula is a multiple of earnings before interest, taxes, depreciation and amortization ("EBITDA"), but many other formulas could be used. Formula agreements can result in a fairly high percentage of problems as well, because conditions can change in the economy and company over time. In some time periods market multiples can be very strong (as they have been lately), while in other time periods market multiples can be much weaker. Formulas don't change as the economy and company change. You can have a situation where owners are looking at a valuation that is not consistent with economic realities at the time the Buy-Sell agreement is invoked.

Valuation process agreements require that a valuation be performed as of the date the Buy-Sell agreement is invoked. While they do not require anything specific about the actual value of the shares, they can be very specific about the process through which value is determined. Valuation process agreements will include definitions and key considerations that must be considered. They can even state who the valuation analyst will be. But they do not give the value of the shares or a formula to determine the value of the shares. The strength of valuation process agreements is that they specifically require the valuation analyst to consider the company and the economy as they are on the valuation date. Valuation analysts are also required to consider the definitions and key considerations that the shareholders put in the agreement so the valuation is consistent with it. A weakness is that it takes some time,



"Valedictorian of your mother's pre-natal class, Captain of the Preschool Napping Team, Dodge Ball Medal of Courage recipient... you sure know how to pad a résumé!"

Corporate Value Partners, Inc.

Ronald D. DiMattia, President, 4545 Hinckley Industrial Parkway, Cleveland, OH 44109
(216) 741-1330 Office
ron@corporatevaluepartners.com • www.dealdesk.com

Corporate Value Partners, Inc.
4545 Hinckley Industrial Parkway
Cleveland, OH 44109-6009

NEWS

Corporate Finance Insights

effort and expense to develop a valuation report, which can still be subject to dispute and further negotiation.

Best Practices

The recommended best practice is to use a valuation process agreement, with the valuation analyst identified, and to have a valuation prepared on an annual basis. The value of the shares is made explicit each year, and the shareholders can directly ask the valuation analyst questions and study their report. Hard-won experience shows that if a company follows these best practices, the shareholders are far less likely to end up in a valuation dispute.

However, an annual valuation requires an annual expense. A compromise that some companies make is to use a valuation process agreement and identify the valuation analyst. But they do not have annual valuations prepared. They may have valuations prepared periodically, or they may even elect to have a valuation prepared only when the Buy-Sell agreement is invoked. Such an arrangement is less expensive, but it provides the shareholders with less information as the company changes over the years. With less information, some shareholders could be unpleasantly surprised with the result.

Corporate Value Partners, Inc.

Please contact Ronald DiMattia at Corporate Value Partners at (216) 741-1330 or ron@corporatevaluepartners.com with any questions or if you need help with a valuation or corporate finance matter.

Corporate Value Partners is a corporate finance consulting firm. Services include:

- **Preparing business valuations**
- **Assisting with the acquisition or sale of a business, business unit or product line**
- **Assisting with corporate performance measurements**
- **Assisting with the placement of debt financing**
- **Assisting creditors in corporate bankruptcies**
- **Assisting attorneys with the financial aspects of lawsuits**