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Building the Better Buy-Sell Agreement

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Apple is one of the largest and most celebrated companies in the world. Apple, like so many start-ups, began with three friends in a garage, Steve Jobs, Ronald Wayne and Steve Wozniak, who founded Apple Computer on April 1, 1976. The least known member of the trio is Mr. Wayne, who purportedly wrote the three men's original partnership agreement and originally owned 10 percent of what would eventually become the most valuable company in the world. However, less than two weeks into the life of the enterprise, Mr. Wayne relinquished his equity for less than $1,000. So how and why did he sell equity that would eventually be worth $70 billion for less than $1,000? As the story is told, the why was Mr. Wayne's concerns about assuming personal liability for the debts of Apple (if not paid, creditors may generally enforce their debt claims against the personal assets of general partners). The how is explained by a commonly used business arrangement called a “buy-sell” agreement.

'Buy-Sell' agreements, the business pre-nup:

Buy-sell agreements are arrangements between owners of a business where one or more owners agree that they will purchase the interest of an owner who withdraws or becomes deceased. Often the agreements may include transfer restrictions which prohibit transfers of stock to outsiders without the consent of the other owners or provisions that commit each owner to sell, and the business or the other owners to buy, ownership interests at a fixed or determinable price upon the occurrence of specific events in the future. Essentially, a buy-sell agreement is similar to prenuptial agreement between business owners, which details the financial aspect of the unwinding of the business relationship. In lieu of a separate agreement, buy-sell provisions for closely held corporations may be included in shareholders' agreements or organizational documents for the corporation. Buy-sell provisions are among the most fiercely negotiated provisions of such documents and often the subject of litigation among shareholders when the provisions are invoked. More often than not, the method of establishing the purchase price is the central issue in the debate or dispute.

Why are valuation methodologies so difficult to agree upon?

It is difficult to agree on the methodology to determine the purchase price for a number of reasons. First and foremost, valuation methodologies are contentious because the interests of the co-owners are adverse to one another. Naturally, sellers want the price to be high and buyers want the price to be low but which owner will be the buyer and which will be the seller? Since generally, owners do not know when forming the corporation who will be the buyer and who will be the seller, there should be a reasonable and balanced negotiation between the owners. However, there may be factors at inception which will lead the parties to make assumptions as to their probable role in the future, for example, if there is a large disparity in the financial means of the owners or other factors which indicate a disparity in power, each owner may negotiate as if that role is a foregone conclusion. Differences in percentage ownership of the corporation may also affect the negotiations. For example, majority owners may consider that their majority position should be valued with a control premium which would discount the purchase price to be paid for owners with a minority ownership position, while minority owners will hope to purchase shares at the same price as the majority owner can.

Second, the event that triggers the right to buy or sell may drastically affect the expectations of the owners and the actual value of the corporation. For example, while a business may be worth millions under the management and direction of one of the owners, the same business may be worth drastically less upon her death. The key owner may rightfully want to ensure that her family benefits from her superlative contributions to the business, however, it is also reasonable to expect that the other owners may not desire to overpay for the business in her absence, especially if there is no life insurance or other financing in place to fund the purchase from her estate. Similarly, the owners may want to discount the purchase price to buy the interests of an owner that is terminated for cause (e.g., illegal activity) that results in the liabilities to the business. In any event, if one of the owners receives an offer for his shares from a third party that is higher than the purchase price determined pursuant to the agreement, such owner will obviously resist being bound to sell his shares for less to his co-owners or the company. The events triggering the right to sell may include termination of employment (with or without cause), death, disability, rights of first refusal or first offer, among others, and accordingly the valuation method must account for such different events.

Third, selecting a valuation methodology is contentious because owners (and their advisors) may have different views about which methodology is appropriate. There are a variety of conventional methods that are used (described below), but none of the methods is universally accepted and reasonable people can disagree about which method is best suited to value the specific business in question.

Fourth, even if the owners are able to agree upon a valuation method at the time of the agreement, unforeseen conditions that occur in the future (when the value of the business is actually determined under the agreement) will almost always result in some unintended benefit or detriment to the various parties to the agreement with the party perceiving itself being aggrieved commencing litigation. Any method that results in grossly inequitable treatment or forfeiture by a selling owner is likely to be so challenged. A year after leaving Apple, Mr. Wayne received $1,500 for his agreement to forfeit any claims against Apple, which had then converted from a partnership to a corporation (an action that would have fully protected Mr. Wayne from his personal liability concerns had he implemented the conversion instead of selling his interests back to his co-founders). The Apple settlement was an amazing bargain in comparison to many court battles that have been waged challenging the validity of agreed upon valuation methods (or fighting the outcome or circumvention of such agreed upon methods on equitable grounds) with millions of dollars at stake.

What types of valuation methods are typically used and what are the advantages or disadvantages of such methods for different types of businesses?

The following summarizes certain conventional methods that are used to determine the purchase price for buy-sell arrangements and certain relevant considerations for closely held corporations:

Appraisal

The appraisal method is valuation by an independent third party (or multiple third parties, e.g., seller selected appraiser, buyer selected appraiser and third mutually selected appraiser).

Advantages:
• Objectivity (of the appraiser)
• Expertise
• May provide the most supportable valuation if the company anticipates a challenge or objection

Disadvantages:
• Time consuming (if annual or periodic outside appraisals are not regularly done)
• Expensive
• Depends upon estimates and assumptions for projections based on historical trends and expected future results that may be disputed
• Gathering appropriate market comparisons and benchmarks
• Subjective determination of key inputs such as discount rates

Special Considerations:
• Early-stage and technology-focused companies may be difficult to appraise using traditional financial metrics and the technical requirements to evaluate such companies may also prove challenging and also raise confidentiality concerns about key know-how and intellectual property
• Best suited for companies with lengthy operating history or value tied to specific assets with a more readily identifiable market value, e.g., securities or real estate

Formula

The formula method utilizes predetermined calculated values, generally based on accounting measurements, e.g., book value, sales, EBIT, EBITDA, net income, asset values, etc., or formulas or metrics special to a particular industry, e.g., oil and gas reserves, or some combination of the foregoing.

Advantages:
• Certain and predictable in advance (if funding is needed to consummate)
• Quick calculation
• Inexpensive
• Can be structured to be similar to criteria that would ordinarily be considered by an outside purchaser, e.g., 5x EBITDA
• Generally correlates to the financial condition of the business

Disadvantages:
• Accounting measurements are inherently backwards looking and business prospects differ materially
• Static, e.g., market conditions for actual transactions may no longer support the agreed upon 5x multiple
• Depends upon accounting estimates, policies and assumptions that may be disputed
• Susceptible to challenge if patently unfair

Special Considerations:
• Regular mandatory review (and revision, if deemed necessary) of accounting measurements selected versus terms of actual comparable transactions is strongly recommended to verify the result is arguably close to fair market value
• Best suited for companies with lengthy operating history in established industries with publicly available market information

Internal Agreed Upon Value

With Internal Agreed Upon Value, each owner (or a predetermined percentage of owners) periodically agree upon the value of each share, which is often coupled with a “back-up valuation” based on a formula method to take effect if an agreed value has not been adopted within a certain period of time (usually 18 months).

Advantages:
• Mutual agreement of owners
• Certain and predictable within the “lookback” period (if funding is needed to consummate)
• Quick calculation
• Inexpensive
• Evolves over time with the expectations and views of the owners

Disdvantages:

• Failure to reach agreement
• Time consuming (if annual or periodic agreements are not regularly reached)
• Static, e.g., business events may materially change in the 18 month or other “lookback” period subject to the agreed upon value
• Lack of financial or business acumen of certain owners
• Disadvantages associated with Formula method if agreed value lapses

Special Considerations:
• Regular mandatory agreement is strongly recommended
• Best suited for companies with familiar and amicable co-owners that are involved in the daily operations of the business and generally capable of compromise
• Not recommended for situations in which there are more than a few co-owners, especially where there are significant disparities in age, health, or levels of active participation in the business which often result in disagreements as to business objectives and distribution of profits to owners

Put/Call Option

With Put/Call Option, each owner has a right to initiate a procedure with its co-owner under which one owner eventually purchases the shares of the other owner, but neither owner knows at the outset who will be the buyer and who will be the seller. The initiating owner (whose intention may be to buy or sell the shares) proposes a price for a sale of the shares. The other owner then must choose whether to sell its shares at this price or buy the initiating owner's shares at this price. Typically, the right to initiate the process is not available for a certain number of years.

Advantages:
• Mutual agreement of owners on price so the price is not likely to be challenged since it is negotiated at arm's length
• Certainty
• Quick conclusion on the value question
• Inexpensive

Disadvantages:
• Lack of financial resources of one owner to purchase the shares of the other
• Does not address the need for a purchase price in the period prior to the put/call right being available
• Generally, only works well with two owners
• Dependence of business on one of the owners, i.e., an owner may feel compelled to sell at any price if such owner is unable to run the business without the other but the opposite is not true

Special Considerations:
• Best suited for companies with two owners with similar external financial resources
• Best suited for companies with co-owners that are both involved in the daily operations of the business
• Careful coordination is required to coordinate the put/call option with provisions of organizational documents related to mergers or sale of the company and drag along or tag along right, to avoid conflicting rights or unjust enrichment

What are some other things to keep in mind related to buy-sell agreements?

Owners of closely held corporations often also serve as officers of such corporations and the different roles may become intertwined so that employment agreements may contain buy-sell provisions and shareholder agreements may contain provisions containing consequences for actions related to employment. Frequently, an agreement will provide that an employee terminated with cause will have his shares repurchased at a discount. Agreements may provide that an employee terminated without cause would have his shares repurchased at their full value, but a voluntary early retirement or a termination for cause may result in a purchase with a substantial discount to full value, or a delayed payout, or both. If there are provisions for sale at a substantial discount, the employee may favor a valuation method that maximizes the estimated value to mitigate the effects of the discount. While requiring a substantial discount in certain circumstances may be typical, excessive discounts that effectively result in the forfeiture of ownership interests are likely to be successfully challenged in court. It is important to coordinate the terms of the relevant employment agreements and the shareholders' agreement and to consider employment law implications.

It is worth noting that irrespective of the valuation method selected, the owner buying the shares (or the business) may need to finance the purchase of the shares. If financing the purchase through a third party, it is very important that valuation coincides with the financing parties' lending guidelines. The selling owner may also agree to seller financing, meaning that the buyer (or the company) pays the seller over time (usually two to five years) on agreed upon terms.

Conclusion

Buy-sell provisions are among the most fiercely negotiated provisions in shareholders' agreements or organizational documents of closely held corporations and often the most litigated. More often than not, the method of establishing the purchase price is the central issue in the debate or dispute. It is critical that the methodology used results in a valuation that can be determined with certainty but is also responsive to foreseeable and unforeseen changes to business conditions in the future. With careful analysis of the industry and market information available to the owners and careful consideration of the business' nature and prospects, the business owners themselves will inform the best valuation methodology to select. Thoughtful consideration of all of these matters and the factors described above and careful planning can save thousands of dollars wasted on unnecessary litigation and also help owners of closely held corporation avoid forfeiting billions of dollars of value in the next Apple or other great company.

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