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Shareholders Agreements: The Buy/Sell Provision

Buy/sell agreements provide investors in private businesses an escape mechanism, but are these agreements counter-productive?

by William S. Hanneman

Individuals investing in private businesses should give careful thought to the potential future need for liquidity. The "buy/sell" agreement is typically the document that provides for an escape mechanism. Although crafted by well-intentioned business people and their attorneys, in many cases, the buy/sell procedures can economically disadvantage the buyer, seller, or both, and can be counter-productive to achieving the intended objective.

A buy/sell agreement attempts to provide a process to accommodate the departing shareholder, while allowing the remaining shareholders to retain control of the business without being economically disadvantaged. The task is to balance the needs of the selling shareholder to obtain liquidity in a reasonable time frame and at a fair value with the desires of the remaining shareholders to not have their investment objectives, horizon,

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or risk be compromised. The buy/sell agreement establishes the procedure to determine the specific compromise. In reality, these objectives are in conflict. Efforts to resolve the conflicts are usually contentious and, invariably, one or all of the shareholders are disadvantaged in the process.

Although there are as many variations of agreements as there are imaginations, most standard forms of agreement outline a process to determine and realize fair value. Three commonly used mechanisms are:

1. Right of First Refusal: The agreement allows the selling shareholder to find a buyer, but gives the corporation and remaining shareholders a right of first refusal, once a bona fide offer is obtained. This process requires the shares to be offered first to the corporation, then to individual shareholders under the same terms offered by the third party buyer. If neither the corporation nor the shareholders elect to purchase the shares, the shareholder is free to complete the transaction with the third party.

Buy/Sell Mechanisms: Implication to Shareholders

	SELLER	BUYER
1. Right of First Refusal	▪ Difficult to attract buyers ▪ Can't force cooperation of company management ▪ No strategic value ▪ Cash?	▪ Lose control of information ▪ Potentially gain unwanted partner ▪ Increased financial leverage
2. "Put" Right	▪ Valuation roulette ▪ No strategic value ▪ Cash?	▪ Valuation roulette ▪ Forced increase in leverage ▪ Damage to future business value?
3. Texas Auction	▪ May not be able to sell ▪ No strategic value	▪ May end up as seller ▪ No strategic value

There are a number of problems with this approach, the foremost being that it is practically impossible to accomplish a sale. Prospective buyers must be willing to invest the effort and expense to evaluate the purchase, often without access to critical information or management's views on the business, only to wait 90-120 days to see if existing shareholders will match the offer. Even if a buyer is found, the value is likely to be meaningfully discounted because of the inability to sell "control" and the requirement of the buyer to enter into the same buy/sell arrangement.

2. Selling Shareholder "Put" Right: This mechanism allows the selling shareholder to force the Company to buy back the shareholder's interest. If the parties cannot agree on value, an independent valuation expert is employed to determine "fair value". This introduces the risk of "valuation roulette," with the conclusions left to an academic exercise which often does not reflect market value. Financing share purchases to buy out a shareholder is often a challenge; so the seller may be obliged to accept a note that is subordinate to the company's bank. As a result, the seller may receive little or no liquidity and the company is saddled with additional leverage, possibly at a time that is detrimental to the business.

3. "Texas Auction": This mechanism presents an interesting way to determine fairness in that the initiating shareholder sets a price for his or her interest and agrees to be either the buyer or seller in a transaction. The problem is that a shareholder wishing to gain liquidity may instead have to buy the rest of the business in order to have sufficient control to sell. If neither party can complete the transaction, the penalty is often a forced sale of the business.

Each of these mechanisms, or variants thereof, has its drawbacks and shareholders should understand the implications before entering into a long-term agreement that

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will affect their investment. The pros and cons of each approach are summarized in the above table.

The inescapable outcome of each of these mechanisms is that all parties are, to some degree, disadvantaged.

(continued p.2)

A SUGGESTED APPROACH

An alternative approach to consider is a set of guiding principles to maximize value for all shareholders. Instead of modifying the investment to meet investors' changing circumstances, the integrity of the investment would be first.

The integrity of the investment objectives and strategy would be protected by guaranteeing ownership continuity for an agreed-upon investment horizon, unless overruled by a super majority.

Following the investment horizon, the majority (unless otherwise agreed) would control liquidity decisions.

Assuming the majority elects to obtain liquidity, it would be accomplished through a process designed to obtain the highest return, while leaving the minority shareholders with an equal opportunity to retain the business.

Investors should recognize that investments in privately held businesses are illiquid. The best protection against disappointment is to know the other investors and agree on the purpose of the investment. An investment theme and a reasonable period of time to achieve the investment objectives should be agreed in advance. Most institutional private-equity investors expect returns to them to occur over a three- to ten-year timeframe, with a final liquidity date of no later than 12 years. Expectations for an individual investment are in the range of 5 to 7 years, but there is no obligation to adjust the investment horizon for individual investors due to individual circumstances. To force a liquidity event, a super majority is typically required. The intent is to allow the business to have a reasonable period to perform and accomplish its business plan, without interference related to changing investor circumstances.

Following the investment period, a lesser standard should be set to allow liquidity to be pursued.When a group of investors is involved, probably a simple majority should rule. In the case of two investors, maybe either should be able to force action. However, all investors should be held to a standard of confidentiality and non-disclosure, to protect the interests of all shareholders.

A suggested mechanism to obtain liquidity is as follows:

1.The shareholder (or group of shareholders) that elects to force a liquidity event should give notice, whereupon the company and/or remaining owners should be allowed a right of first offer. If accepted, the problem is solved.

2. If the first offer is not accepted, the selling shareholders could force the Board to pursue a managed sale of the entire company designed to achieve the highest possible value for all shareholders. Any offer that results in a value that is greater than the first offer would be accepted and all shareholders must participate. If the best offer is less than the first offer, the non-selling shareholders would have the right to complete a transaction at the lower value.

3. During the sale process, any shareholder should be accorded the same opportunity to bid for the business as outside buyers.

This process makes it very clear that investors are signing up for an illiquid investment. These rules are designed to preserve the integrity of the investment objectives over the personal situation of individual shareholders. All shareholders would be treated equally, based on the initial objectives established at the time of the investment. Bad feelings may erupt based on business judgment, diverging objectives, and changing personal circumstances, but the fear of being economically disadvantaged by an investor-initiated event would be avoided. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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