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INSIGHT
PERSPECTIVES ON THE CAPITAL MARKETS

REPRINT
SPRING 2020

Buy-Sell Agreements—Managing Conflicts

Good intentions vs. good planning.

by Mike Dannenberg

When there are partners in a privately held business, it is not unusual that at some point their investment horizons, tolerances for risk, or requirements for liquidity will diverge. Because privately held businesses are "private," they have no established market value and have no ready market to gain liquidity. This is no surprise to business owners, so to solve this problem upon formation of the partnership, owners often enter into arrangements to describe what will happen when the time comes to separate—commonly referred to as "buy-sell agreements," among other names. However, what is great in concept and intent can become very challenging in reality. We bring this up because we have recently worked through the thorny issues surrounding buy-sell agreements in the context of several transactions, and we have seen the result of agreement provisions leading to unintended consequences.

Unless the partners agree that the business will be wholly sold when any one partner wants liquidity, a judgement will have to be made as to a fair value and payment mechanism for the seller's interests. The conflicts can be enormous for very valid reasons on both sides. The selling partner clearly wants to receive a "market" price for his or her interests, recognizing all the potential of the business, including taking advantage of potential strategic value that could be obtained if a sale of the business occurred. The buyer, on the other hand, will be burdened with additional leverage to fund the buyout (thereby changing the risk-reward equation) and will want to pay as little as possible to protect against downside risk. It is difficult to envision a scenario in which buyer and seller are aligned on incentives for setting a price.

WHAT COULD BE MORE FAIR THAN TO DEFER TO INDEPENDENT EXPERTS?

A common construct of buy-sell agreements is that each party hires an expert to render an opinion of value and, if they do not agree, a third independent expert settles the disagreement.

The problem with valuations is that they depend almost entirely on assessments of the future, for which nobody can predict and conclusions can fairly and logically vary widely. Two (or more) rational analysts can view the future of a business differently, and can come to different conclusions depending on their assessment of the drivers of future performance

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and their weighting of those drivers' relative importance. Valuation experts are no different—although their analyses may be rooted in quantifiable metrics and clear calculations, the truth is that these judgements are more art than science and, as such, experts can disagree wildly. The room for intellectual variation gives an expert the ability to craft an opinion that fits the viewpoint of his client.

Although valuations should in theory be independent of process, the manner in which a neutral third party arbitrates can significantly impact the incentives for each side's rendered opinion.

Appraisers for the sellers can present substantial anecdotal data on comparable transactions that, when chosen carefully, can suggest an attractive value of the business. This is particularly so when there have been industry consolidation transactions wherein the price paid by the buyer might reflect some expectations of synergies between the companies. It takes meaningful insight and judgement to decide if similar synergies (and their value) could be captured by the appraised business, and to what degree.

Industry context aside, the valuation of any specific business is to the greatest degree determined by information provided by the company, specifically the forecast and the associated narrative around expectations for future performance. Significant value can be gained or lost based on how information is presented and the conviction with which it is delivered. Buyers have a decided advantage here in influencing expectations for the future because of their alignment with management. Management has a level of knowledge about the details of the business such that they can confidently present a convincing conservative view of the future of the business. The fact that management will be retained by the buyer should not be dismissed as a factor in influencing their views.

THE GAME CAN BE CONSTRAINED TO INCENT AGAINST BAD BEHAVIOR

Although valuations should in theory be independent of process, the manner in which a neutral third party arbitrates can significantly impact the incentives for each side's rendered opinion. Process steps designed to incentivize fair, intellectually robust analyses can actually incentivize overly aggressive or conservative valuations. For instance:

- Some agreements provide techniques for averaging to settle differences. For example, if there is less than a 10% difference between the buyer and seller, the two are averaged and a third appraiser is not needed. Owners often like this because it appears to provide an opportunity to avoid additional costs and get to an answer. However, our experience is that this method actually encourages divergence of opinion—from the perspective on each side, there is no penalty for pushing the envelope and providing an aggressively high or low value.
- A second construct is that if the difference between opinions is outside of an agreed percentage range, a third opinion is obtained, with this expert having the benefit of all of the other appraisers' work. The thought is that this would allow someone neutral to view all the arguments and render a fair opinion. In practice, third appraisers often split the baby

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in some way to avoid appearing “unfair” and exposing themselves to liability down the line, leaving no penalty for being aggressive in expressing a viewpoint in each side’s original appraisal.

In contrast, one technique we have seen work as designed is the ‘baseball” method, in which a third-party appraiser is instructed to simply choose the most appropriate of the two appraisals, and is not tasked with rendering a third opinion. In this scenario, aggressively pushing the limits in an initial appraisal is risky, in that the other side may be viewed as more reasonable and will end up being chosen by the third party. The marginal value claimed by (or not claimed by) the appraisers in their zeal to get the best result for their client can come at the cost of reasonability in the eyes of an independent observer, and is therefore disincentivized.

PLANNING AHEAD CAN IMPROVE FAIRNESS

Since it is in all parties’ interests to have a fair result up until the time when incentives diverge, partners can engage in several processes that will set the stage for a fair, smooth process if and when the time comes to execute a buy-sell arrangement.

The most critical is to engage in a rigorous planning process each year to develop a projection for the business, as well as to identity areas of opportunity and risk and the requirements to take advantage of or mitigate. This will provide a background of information that is uncolored by the event and gives a factual basis for value that remains independent of a future transaction.

The other is to review buy-sell agreements outside of the context of a transaction. A buy-sell process that avoids drawn-out litigation and distractions to the business should be attractive to all parties. The mechanics of agreements can be adjusted during “peacetime” to ensure that the result of the process is as intended.

Each partner entering into a buy-sell agreement should enter the process with eyes wide open, understanding that there are many factors not under their control that can influence the outcome. Although buy-sell agreements aren’t a perfect mechanism for solving liquidity differences, they’re certainly better than not having a plan at all—and when put in place under careful consideration and in the context of other systems designed to incent a clean process, they can work as designed. **ZS**

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ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions through three service lines: sell-side M&A, acquisition and investment advice, and direct investing. For more information on Zachary Scott, go to **ZacharyScott.com.**

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