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## Thoughts Regarding Your Buy-Sell Agreement

By Dennis Monroe

The last three years has created change in the restaurant industry, so it's important to look at your exit strategy, which should include a review of buy-sell agreements. To address some of these issues, I relied on the input of Scott Roehr, a valuation expert whose practice has been focused on the restaurant industry for the past 25 years.

First here are some legal concerns when looking at buy-sell agreements:

**1. When will the buy-sell agreement be implemented?** We call this a triggering event. Common reasons include the death or incapacity of an owner; active, involuntary transfers, such as divorce or some kind of insolvency; one partner wants to sell or an outright sale which hasn't been approved by other partners. It can also be a right of forced sale when the designated time has passed after the partners had a trigger event, in order to sell the company or individual assets. The key is to ensure these events are clearly defined, when they occurred and when the work for executing on the triggering events will be completed.

**2. Next is the structure of the buy-sell.** Is it a cross purchase or an entity purchase? This may depend on which state the corporation or LLC is located, and whether the buyer wants a step-up basis in the company assets on the purchase. This needs to be spelled out in the buy-sell agreement.

**3. How the buy-sell price is paid?** Is it cash or an installment note? Does the partner who's buying out the other partners or the company itself have the capability to fund this buy-out?

**4. What's the valuation?** What is this company worth? What are the shares of stock worth?

Now for Roehr's input. Most of his work in the past five years has related to partnership and shareholder disputes. A good buy-sell agreement will avoid those disputes by specifying key definitional issues and a price-setting methodology. With regard to definitional issues, Roehr cites a couple starting points:

**1. Standard of Value/Level of Value:** Discounts for lack of control and lack of marketability frequently loom large in many negotiated buyouts. Specification of a fair market value standard on a financial control basis is commonly proscribed to avoid this issue.

**2. Valuation Date:** Timing matters. Business values ebb and flow as the result of changes in the industry, economy, and financial performance of the business. Either date of the trigger event or the preceding fiscal-year end are common specifications.

There are three common price-setting methodologies. The first is an agreed-to price between the parties of the buy-sell. This will specify the agreed-to price is to be updated annually. While this can work, it doesn't necessarily mean an accurate appraisal of the subject equity interests and the proscribed updates are frequently neglected. Roehr recommends if you use this approach, you have periodic valuations performed to support the agreed-to price and develop a consensus regarding the valuation methodology.

The second methodology is use of a valuation formula. This methodology most relied on in the restaurant industry is based on a multiple of EBITDA. But there are factors that become problematic with this set-it-and-forget-it approach: the appropriate market multiple, the earnings it should be applied to and other valuation adjustments required to produce a credible result. It's helpful to use a valuation expert to ensure your formula will work as intended and to recommend changes when updates are required.

The third methodology involves defining the valuation process, in which one or more independent appraisers are retained to establish the price. The structure can run the gamut from retention of a single appraiser to a multiple-appraiser process, where a third appraiser is called in the event the valuations of the first two are more than 10 percent apart. If you used the single-appraiser process, it's helpful to have appraisals performed periodically prior to a trigger event to identify issues in the buy-sell specifications and manage expectations of the participants.

What doesn't work well? When parties don't have an agreement regarding the parameters above, they will frequently retain multiple valuation professionals to perform appraisals then attempt to negotiate a solution.

This tack can yield some wildly disparate appraisals, according to Roehr, frustrating the negotiation process after investment of considerable time and expense.

While it's harder for parties to agree on valuation details after a trigger date, it can be in everyone's interests to work through their issues first, and then a valuation process that will result in an agreed-to price. Whatever the process, it needs to end with a resolution. If your agreement is to get one or more valuations completed and use those to negotiate a buyout, you are not done. Agreeing to a resolution process, which could be an appraisal or arbitration process, can help avoid getting stuck.

Providing for reasonable solutions for as many events as possible in the ownership group, along with a well-thought-out valuation approach, both of which are supported by outside expert advice, provides a smooth transition and exit strategy and stability for the owners.

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