Determination of the Value of a Business for Purposes of a Buy-Sell Agreement

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A buy-sell agreement explains how ownership interest in a business may be transferred if an owner wishes to sell, retires, divorces, passes away or becomes disabled ("trigger events"). An effectively designed, written and funded buy-sell agreement can help avoid undue stress and financial problems at the trigger event. However, if the buy-sell agreement isn't supported by a business valuation prepared by an expert, it can be subject to protracted litigation. In fact, of all the elements in a buy-sell agreement there is one area that is litigated more than any other area – and it is the area of compensation paid to the departing stockholder in exchange for their stock. Such lawsuits are common because the disputed agreement was either silent or unclear about the method of valuation of the business, the process of determining the value, who will perform the valuation, who will pay for the valuation, and the timing of the payments for the stock.

DETERMINING VALUE

There are several ways to determine the value of a business for purposes of the buy-sell transaction in the agreement. These include:

Fixed Price Agreement

Fixed Price Agreements state in the actual document the value of the business as of the date the agreement is signed. While this makes for a clear, easy to- understand agreement, they also become obsolete almost as soon as the ink dries. The value of a business is not static and must be updated each time a trigger event happens. By stating a value in the agreement it is often thought that the difficult issues of value have been eliminated. In fact, they have just been deferred. A departing owner of a business that has grown to be worth millions of dollars will not accept a negligible amount upon their departure simply because a buy-sell agreement that is several years old says that is what the business is worth.

Formula Agreement

A Formula Agreement is easy to understand and easy to negotiate as the agreement simply states the formula that will be applied when the trigger event happens. For example, "the value will be four times net income." Formula Agreements leave open the possibility that "the other owners" will manipulate one or more of the variables. In the example given, net income can be manipulated through the issuance of bonuses to the remaining owners so that net income is negligible. A significant problem with Formula Agreements is that the variables are rarely defined adequately. "Net income" should be defined, for example, as before or after tax, before or after owner compensation, before or after extraordinary items, cash basis or accrual basis, audited or not, etc.

If the formula involves a multiple of income statement measures, the agreement should also explicitly address whether or not the balance sheet is part of the valuation. As simplistic as it seems, an income statement measure should be based on an annual amount; that factor should not be left to be an assumption. The agreement should state that annual results are used and that they are the most recent twelve months, or the prior fiscal year, etc. It is also a general rule that the higher you go up the income statement the less opportunity there is for manipulation. For example, a multiple based on net income is much easier to manipulate, as already discussed, than a multiple based on gross revenue.

Formulas that are based on historical balance sheets will almost always be disregarded by the courts and the IRS as a measure of fair value since assets are recorded at historic cost basis. At most, net book value may be useful to determine liquidation value. Liquidation value is not a legitimate standard of value for a going concern business. Book value formulas do not address the value of goodwill, pending liabilities and lawsuits, inventory adjustments, etc. Therefore these types of formulas should be avoided.

If a formula is to be used, the formula should be applied and tested using current financial information as well as projected under several realistic assumptions to make sure that the formula produces reasonable results under all conceivable eventualities. Running projections in this way also assists in determining the amount of life insurance that will likely be needed to fund the buy-sell agreement. Additionally, the difference in valuation of control vs. non-control interests should be addressed in the agreement and contemplated in the application of any formula.

Blind Agreement

Blind buy-sell agreements do not state a value of the business or a formula for valuing the business. Such agreements define how and when an offer to buy will be made. Implicit in this type of agreement is the assumption that the remaining stockholders will make an appropriate offer at the appropriate time for a reasonable amount. Blind agreements are easy to understand, easy to negotiate, and inexpensive mostly because the difficult issue of valuation is not addressed. It is simply an issue that is being ignored and put off for a future day – and hopefully never. A blind agreement makes some sense for a 50%/50% ownership structure. However, if there are any non-control interests in the ownership structure a blind agreement would be a big gamble for the non-control owner and is almost always a formula for future litigation.

Process Agreement

A Process Agreement details how, in the future, the business will be valued. There is generally no prescribed formula in the agreement. Sometimes an appraiser is named but more often a process is established to identify a qualified appraiser in the future. There are several types of processes that can be established in a Process Agreement:

- One appraiser is to be used and the result of that process will be accepted by all parties. This is fairly common because it is simple, understandable, and often favored by the attorney drawing up the agreement. Some disadvantages of this form of a process agreement includes the possibility that all parties are unhappy, bias can be alleged against the appraiser, and costs as well as valuation are unknown until the trigger event

has already happened. In other words the valuation process is a big mystery until it is too late to affect the process.

- Two appraisers are hired (one by the buyer and one by the seller). If the two appraisers do not agree (they never do) the two results are averaged. Alternatively, a two-appraiser agreement can dictate that if there can be no agreement then it goes to arbitration, mediation, and/or litigation.

- Several appraisers can be dictated as follows: Two appraisers are hired. If they disagree, a third appraiser is identified/chosen by the original two appraisers. The third appraiser either selects one of the original two appraisals or prepares a whole new appraisal.

Several advantages of a multiple appraiser agreement should be noted. The most significant is that the process, timing, and structure are known in advance by all parties. Often, everyone who is a party to the buy-sell agreement feels protected by the knowledge that they will have "their" appraiser involved in the process. This, however, is often an illusory advantage.

A multiple appraiser process, by its design, puts appraisers in an advocate role ("My appraiser…"). Once that happens, the process becomes fraught with the potential to create the very conflict, disruption, and emotion that the agreement was designed to minimize. The time and inconvenience involved in having several appraisers combing through the records and operations of the business can also create tension and delay resolution of the issue. Since "time is money," it follows that having multiple appraisers involved will greatly increase the cost of the process.

AVOID AMBIGUITY

Ambiguity is the mother of litigation. To the extent possible, the valuation element of a buy-sell agreement should be carefully considered, discussed, and negotiated. The details of the agreement should then be described and recorded as clearly as possible in the buy-sell agreement.

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