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Business Valuation in Buy-Sell Agreements

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There is no better time to plan for the break-up of a business relationship than while the relationship is forming. Determining the timing and conditions of the departure of an owner of the business at the beginning of the relationship is the most efficient, and least expensive, time. Unfortunately, this is rarely when this type of planning takes place. All too often, it is not done until both parties are in court asking a judge to resolve the issues. This is, by far, the most expensive and least efficient way to determine how and when a business relationship is terminated.

A road map to the end of a business relationship between the owners of a company is often referred to as a "buy-sell" agreement or a "stockholder agreement." The buy-sell aspect reflects the need to consider not just the conditions of separation but also the value and timing of payments for stock owned by the departing stock-owner. A workable agreement is clear, concise, and comprehensive. It will address the termination of the relationship under every conceivable condition including, death, disability, retirement, termination of employment, and sometimes divorce.

There are several key components to these agreements that are legal in nature. This article will focus on the issues surrounding the valuation of stock held by the departing stockholder and not the legal issues. 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. Lawsuits are common because the disputed agreement was either silent or unclear about the method of valuation, the process of determining the value, or the timing of the payments for the stock.

The key to a strong buy-sell agreement is clear language defining how the business will be valued, when it will be valued, who will do the valuation, and who will pay for the valuation.

Several questions should be answered in the buy-sell agreement that will define how the business will be valued:

- **Standard of Value –** this issue can make an enormous difference in the conclusion of value. If Fair Value is used there will likely be no discounts applied to minority (non-control) interests for lack of control or lack of marketability. If Fair Market Value is used then the discounts would be applied to minority interests. Another concern is that the court that eventually hears the trial in a stockholder dispute will be using a statutory definition of the appropriate standard of value. To the extent the buy-sell agreement uses a different standard of value than defined in the dispute stage, the money spent on having the business appraised may be wasted. This is also relevant in the event that a partner dies and the stock is to be valued for estate tax purposes. If the appraisal and buy-out is on the Fair Value standard, it will be useless for estate tax purposes as the Internal Revenue Service requires valuations to be done on the Fair Market Value standard.

- **Valuation Date –** most buy-sell agreements define trigger events requiring a valuation to be done to facilitate a buyout. The agreement should state whether the valuation takes place "as of" the trigger date, the most recent month-end prior to the trigger event, the next month-end after the trigger event, end of the prior year before the trigger event, etc.

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There are endless choices here that could mask the importance of the actual selection of valuation date. For example, a valuation date after the trigger event opens up potential ambiguity that could allow the buyer to value the shares without the impact of the seller who may have been a key person who generated significant income for the business.

- **Funding –** a business valuation is potentially worthless if there is no way for the buyer (corporation or remaining stockholders) to realistically finance the purchase. Describing the expected funding mechanism affirms that the reasonableness of the buy-out valuation has been considered and planned for. Very often, this part of the agreement is tied to insurance contracts that are to be purchased by the corporation or the owners of the corporation.

There are several ways to handle the determination of the value of a business for purposes of the buy-sell transaction in the agreement. The most obvious and all too common method of addressing the issue is to ignore it. The following details other methods – all of which are better than ignoring the issue. The above issues should be clarified in the agreement regardless of which of the following methods are used to determine the actual value of the business.

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.

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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.

CONCLUSIONS

Every business situation and ownership structure is unique. What is sure is that the ownership relationships in every business will change and even end. Whether by death, disability, retirement, disagreement, or some other reason, the ownership of a company is not permanent. Preparing for the inevitable should be common sense but is one of the more neglected aspects of financial planning. The neglect is a product of a combination of ignorance, laziness, or an attempt to not "rock the boat" as a business relationship is being formed.

For those who do tackle the task of planning for the end of a relationship, a complex world of valuing a business is opened up involving accounting, the law, and economics. A good plan requires difficult conversations, thought, and some what-if analysis. What often results is an agreement that is the product of good intentions matched up with limited knowledge. On top of that, it is common that a buy-sell agreement is signed, filed, and forgotten until the day comes when it is needed. In the intervening years the agreement has become obsolete and/or everyone disagrees about the intent and meaning of key provisions.

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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. The three legs to the valuation platform of a good buy-sell agreement are 1) a knowledgeable lawyer, 2) an experienced business valuation expert, and 3) a competent financial planner that can assist the owners with the analysis of funding the eventual buyout. In collaboration with the owners of a company, this team should be able to address adequately the issues of valuation.

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