

Buy/Sell Agreements: *A Business Valuation Perspective*

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Buy/Sell Agreements provide a blueprint for the transfer of business interests, allowing business owners to control and protect their investment in an organized and prescribed manner. Think of the Buy/Sell Agreement as a prenuptial between business partners.

Buy/Sell Agreements address certain unforeseen *triggering events* such as death, incapacity or divorce – as well as planned events such as an orderly transition – and should therefore be an integral part of every business planning process. Ideally, very early in the process. A well-constructed Buy/Sell Agreement serves five crucial functions:

- ✎ Creates a ready-made market for a company's shares or membership interests upon the occurrence of a triggering event or other predefined transfer scenario;
- ✎ Defines the price at which shares or membership interests will be transferred and the terms of the transaction (i.e., time period, interest rate, timing of payments, etc.);
- ✎ Ensures that any transaction is funded in a prearranged manner;
- ✎ Imposes transfer restrictions that protect the integrity of the ownership structure;
- ✎ Allows for succession and estate planning needs while mitigating possible conflicts.

Buy/Sell Agreements are often incorporated into a company's operating or shareholder agreement. As a business valuation consultant, I have reviewed hundreds of such documents from the standpoint of how ownership interests will be priced when a triggering event occurs. More often than not, there is a disconnect between the actual outcome and the original intentions; rather than serving as a vehicle for an amicable transfer of ownership interest, a poorly drafted Buy/Sell Agreement can result in gross inequities, almost ensuring a path to litigation.

Defining Price

Generally, there are three ways that Buy/Sell Agreements address value. Price is either:

- ✎ **FIXED** at the outset and then adjusted periodically;
- ✎ Set by a **FORMULA** that "kicks in" when a triggering event occurs; or
- ✎ Initially determined through an **APPRAISAL** process and updated at predetermined intervals and, if necessary, upon a triggering event.

FIXED-price agreements are generally easy to negotiate and involve little expense. However, they are often based on values that rarely reflect the actual fair and equitable value of a company's shares or membership interests. Further, contrary to intentions, they are often not periodically updated. This is problematic because after a triggering event, the respective parties' interests are no longer aligned and in fact, may very well be diametrically opposed, meaning that agreeing on a fixed price after the fact is almost (if not always) impossible.

Agreements based on a predefined **FORMULA** are generally easy to understand and, as with the fixed-price approach, are easy to negotiate and involve minimal expense. Nevertheless, formulas necessarily rely on variables. Over time, the variables that drive the value of a company can differ depending on changes within the company, the industry and the economy. A formula appropriate at one point in time may not be meaningful in the future.

Unlike the fixed-price and formula approaches, the **APPRAISAL** process incorporates the relevant information and conditions *each time* price is determined. Further, an appraisal conducted by a qualified business appraiser ensures that an independent and objective opinion of value is rendered. Additionally, an initial appraisal allows for a "test drive" of the Buy/Sell Agreement *before* the occurrence of a triggering event. In this way, any kinks in the process can be addressed while the respective parties are still sitting on the same side of the table.

Factors Affecting the Appraisal Process

Any factor required by the appraisal process that is not specifically spelled out in the Buy/Sell Agreement will result in certain assumptions having to be made by the business appraiser. Leaving material facts open to interpretation can result in a very different determination of value than that originally intended.

The following five factors impact how price will be determined by the appraisal process. These factors should be explicitly defined within the Buy/Sell Agreement.

1. Appraiser Qualifications

Without specifying any qualifying criteria, anyone could be called upon to determine the price of the Company's shares or membership interests when a triggering event occurs. Therefore, it is important that the Buy/Sell Agreement require that the appraisal be performed only by a *Qualified Independent Appraiser*. This person should hold a designation sponsored by a recognized appraisal organization and have the requisite appraisal training and experience. Examples of appraisal designations include ASA, CBA, CFA, CPA/ABV and CVA. Credentialing and membership in an appraisal organization ensures that the appraisal will be performed in accordance with the appropriate professional business appraisal standards.

2. Valuation Date

This is the effective date of the determination of value. This date dictates what relevant facts can and cannot be considered in appraisal process. The choice is critical because it can determine whether or not the triggering event itself can be considered. In the case of an unanticipated loss of a key person, whether the valuation date is the month-end preceding or subsequent to the triggering event could have a dramatic impact on the price determination. Further, even though certain events can be reasonably anticipated, their timing and probability of occurrence may not be known with any certainty.

3. Standard of Value

"Value" has many meanings. While it seems trivial, the difference between *Fair Value* and *Fair Market Value* can be considerable. Business appraisal is not a one-size-fits-all proposition – the desired standard of value is critical to a successful appraisal process. I have read many Buy/Sell Agreements that call for "book value." The fact is that book value is not a *standard* of value, but rather an *approach* to value; and is not appropriate for all situations and certainly not for all types of businesses. I suggest that in most cases the Buy/Sell Agreement stipulate the *standard* of Fair Market Value and let the professional appraiser determine the most appropriate valuation *approach*.

4. Basis of Value

In the world of business appraisal, there is a quantifiable difference between a pro rata share of the value of a business and the value of a fractional interest in a business – especially if the fractional interest is less than a controlling interest. While the mechanics of the appraisal process tend to get a bit technical, suffice it to say that it is important to indicate the *basis* of value to be used in determining the price of each respective party's shares or membership interests.

5. Funding Mechanism

While the funding of the Buy/Sell Agreement doesn't necessarily affect the appraisal process, there is some interrelationship between the two. Typical funding mechanisms include life insurance and/or promissory notes. Other options are cash (accumulated over a period of time) and external financing. The appraisal process can help determine which options are most affordable (fair & equitable) under any given set of specific terms. In respect to life insurance, the Buy/Sell Agreement should indicate whether any proceeds are treated as company assets (i.e. included in the value of the company). This decision can have a substantial impact on the determination of price.

Conclusion – Avoid Conflict and Confusion

Legal and tax advisors should be proactive in stressing the importance of either implementing a Buy/Sell Agreement or, if one is already in place, having it reviewed to ensure the avoidance of unintended consequences. In addition to a legal and tax review, a professional business valuation consultant can assist in identifying any potential valuation concerns. Once an appropriate Buy/Sell Agreement is in place, I recommend that it be taken on a "test drive" by having a business appraisal performed. This will determine the extent of any differences between the intentions of the Buy/Sell Agreement and its actual effect on price. It will be much easier to address any valuation issues *before* a triggering event occurs than afterwards when potentially adverse circumstances exist and the parties are no longer sitting on the same side of the table.

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