Buy-sell Agreements: Cover all the valuation bases

Even the most successful business may eventually falter without a reliable buy-sell agreement. Why? Buy-sell agreements act as a form of insurance to protect companies during significant ownership changes. These changes may be foreseen, such as an owner's retirement, or completely unforeseen, such as an owner's death or a dispute among shareholders. A good agreement's buyout terms and provisions can ensure the company remains stable and solvent through upheaval — and that the departing owner (or his or her family) receives the appropriate payout.

But an inadequate buy-sell agreement may be worse than no agreement at all — giving owners a false sense of security. That's why it's important to consult with an experienced valuation professional to ensure your agreement covers all the valuation bases.

First, second, third — and home

When setting up or revisiting a buy-sell agreement, business owners need to:

***Get to first base: Define buyout terms*.** Comprehensive buy-sell agreements explicitly define the appropriate standard and basis of value to apply to owners' interests. For example, an agreement might prescribe "fair market value" as defined in Revenue Ruling 59-60. For minority interests, fair market value implies a minority, nonmarketable basis of value. Conversely, an agreement might use the term "fair value" and define it to refer to each owner's pro rata share of the entire company's controlling, marketable value.

Other important valuation parameters include the appropriate "as of" date and payout mechanisms. Funds might be generated from life insurance proceeds, bank loans or seller financing. If exiting owners (or their estates) will be paid over time, it's important to specify duration, interest rates and variable-rate market indices.

***Continue to second base: Avoid ambiguous or outdated valuation formulas*.** Some buy-sell agreements prescribe valuation formulas to avoid the time and expense of hiring valuators. Unfortunately, these formulas may be oversimplified or outdated.

Consider an agreement that stipulates the company is worth five times annual earnings. What does the term "earnings" really mean? One valuator might assume it refers to accounting net income and another might use pretax earnings, adjusted for nonrecurring items and quasi-business expenses. Different interpretations can lead to substantial variance in opinions.

Or imagine that the hypothetical company has been reserving cash to purchase land adjacent to its plant for future expansion. The prescribed rule of thumb doesn't account for excess working capital and, therefore, is likely to undervalue the business. Conversely, if the company has significant contingent liabilities — for example, environmental cleanup or pending lawsuits — the formula might *over*value the business.

***Reach third base: Specify the financial data to be used*.** Suppose an owner dies on Jan. 10, 2013. Would the valuator rely on 2011 audited financial statements, unaudited internal records for the trailing 12 months, or the 2012 audited financial statements (which might not be available until April 2013)?

Thorough buy-sell agreements specify how to determine financial statement dates and the requisite level of assurance (compilation, review or audit). If controlling owners engage in financial misstatement or deny minority shareholders' access to facilities or financial information, agreements also might call for forensic accountants.

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Buy-sell Agreements: Cover all the valuation bases *(continued)*

***Hit home: Predetermine the agreement's appraisal timeline*.** Remaining shareholders seldom are in a hurry to buy back shares, but exiting shareholders — or their surviving family members — have a financial incentive to cash out quickly.

Valuation often takes longer than owners anticipate, especially if the buy-sell agreement calls for multiple experts or valuation disputes arise. Predetermined timelines can establish reasonable expectations and help ensure buyouts are completed in a timely — but not rushed — manner.

Win the game

Don't handicap your team by failing to ensure the valuation under your agreement will be well reasoned and supportable or failing to update the agreement periodically as circumstances change. With foresight and the help of an experienced valuator, you'll win the game.

TO DISCUSS THESE OR OTHER BUSINESS VALUATION MATTERS, CONTACT:
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