BUY-SELL AGREEMENTS

What you need to know to avoid purchase-price conflicts

By Kevin J. Wilson

Attorneys and most experienced business owners know the importance of buy-sell agreements and the critical role they play in facilitating the transfer of a business interest if and when a certain event occurs.

As defined by Investopedia: "A buy and sell agreement is an approach used by sole proprietorships, partnerships and privately-held corporations to divide the business share or interest of a proprietor, partner or shareholder. … The buy and sell agreement requires that the business share is sold according to a predetermined formula to the company or the remaining members of the business."

The focus of this article is the key phrase in the definition: "predetermined formula" or the method of determining the purchase price. This can be the most challenging part of the agreement. What business owners ultimately want the buy-sell agreement to accomplish is to make the process of ownership transfer as smooth and conflict-free as possible. This means setting a fair and reasonable purchase price that is agreeable to all involved parties.

Surprisingly, many business owners have had buy-sell agreements drafted only to realize upon the triggering event that the terms of the agreement present conflicts among the owners — a situation that they intended to avoid in the first place. Many times this is the result of crafting an agreement with cookie-cutter terms that are not quite right for the interested parties or are skewed in favor of one or more of the parties.

The manner of determining the purchase price (also referred to as value) is one area that requires thoughtful consideration when drafting a buy-sell agreement. It is important to understand the different valuation approaches and their usefulness and applicability when considering the nature of the business and the goals and aspirations of the business owners. Factors such as cost/benefit, fairness and credibility also come into play.

Most valuation approaches for buy-sell agreements fall into one of the following four categories:

1. Fixed Price — The buy-sell agreement sets the purchase price at a specific dollar amount.

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Choosing the right valuation approach is a balancing act for business owners.

2. Formula-based — The purchase price is based on a specific metric: for example, using book value or an earnings multiple such as EBITDA (earnings before interest, taxes, depreciation and amortization).

3. Methodology-based — The agreement specifies that an appraiser use a particular valuation methodology such as the market method (based on selling prices of similar companies that were sold or acquired), discounted cash flow (predicting future cash flows and discounting them back to present value), etc.

4. Independent Business Valuation — Uses a qualified appraiser to report on the value of the business using his/her professional judgment as to the methodologies employed and the degree of analysis involved.

Following is a summary of the advantages and disadvantages of the four categories used in determining the purchase price.

Fixed-Price Method

Advantages:

- Simple, easy to calculate, easy to understand.
- Inexpensive, doesn't require a third-party appraiser.
- Can be used as a protective device for the owners if a low price is intentionally set to inhibit a key person from exiting.

Disadvantages:

- Can be deemed outdated/obsolete since the fixed dollar amount doesn't allow for varying business conditions that can affect value.
- Factors affecting value are rarely static; an entity's business can easily change in a short time, rendering a fixed price unreasonable or unfair.

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Formula-Based Method

Advantages:

- Relatively simple, easy to calculate, easy to understand.
- Inexpensive, doesn't require a third-party appraiser.
- Has the ability to reflect an updated value.

Disadvantages:

- Being tied to one formula may not reflect the realities of an entity's changing business.
- Formulas may not consider extraordinary/unusual events.
- May rely too much on historical operations and ignore future expectations, which can be quite different.
- Formulas may not address key risks or positive attributes.

Methodology-Based Method

Advantages:

- More in-depth analysis.
- Not as expensive as a full business valuation.
- Can reflect an updated value.
- Can be better tailored to incorporate a business's unique and changing circumstances.

Disadvantages:

- Methodology may not be appropriate over time as the business changes.
- Usually more expensive and time consuming than fixed-price or formula-based terms.
- Typically more subjective than fixed-price or formula-based terms; there is more potential for disagreement.

Independent Business Valuation Method

Advantages:

- Most in-depth and analytical.
- Third-party, independent opinion adds to credibility.
- Considers all aspects of an entity's business, including historical and future operations, risks, etc.
- Considers all valuation methodologies, as appropriate.

Disadvantages:

- Most expensive.
- More time consuming.
- Risk of a dissatisfied party if the result is binding.
- May lead to a second appraisal if there is disagreement over the results, which adds to cost.

As you move from fixed-price to independent business valuation, the cost and the level of judgment and analysis increases but there is more flexibility in estimating value.

As any business owner knows, business changes over time, sometimes dramatically. Relying on a fixed-amount or formula-based method for a buy-sell agreement is quick, inexpensive (no third-party appraisal) and may have been appropriate years ago, but may not be now. For example, the company's business may not be capital intensive (it may not hold a lot of hard assets) but may have developed significant intangible assets over the years, such as a large customer base, a brand/trademark or goodwill — all of which are not recorded "on the books." In such cases, using a fixed-price value may not be the most appropriate method unless there is another overriding reason to use it (such as the low-price-protection feature noted earlier).

In another example, let's say the pricing metric, as prescribed in the buy-sell agreement, is a multiple of historical EBITDA (a common rule of thumb used by investors). If the business has been generating low EBITDA but has better prospects for the future (possibly from a significant new customer or planned cost reductions), then using historical earnings would not capture the added value from the positive outlook. Or historical EBITDA may not reflect true earnings since there may be one-time and/or personal expenses embedded in the financials (common with small, privately held companies). This would also lead to a flawed valuation result, which has the po-

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tential to create conflicts among the parties involved. There are myriad other examples that can cause valuation problems due to the use of inappropriate methodologies.

The methodology-based and independent business valuation approaches use more in-depth analysis and more art than science in determining value. The methodology-based approach requires judgment within the context of whichever method is prescribed. For example, if the buy-sell agreement calls for use of the market method or rule of thumb, the appraiser will use his or her judgment in estimating an appropriate pricing multiple in cases where there is a range of industry pricing multiples. This option can better capture a company's changing business compared to the fixed-price and formula-based approaches since the appraiser has some leeway in factoring the entity's positive (or negative) attributes that are not reflected in the business's historical operating results.

The independent business valuation gives the appraiser a free hand in valuing the subject interest as he or she sees fit. In other words, the appraiser is not encumbered by any one methodology and uses his or her professional judgment to select the most appropriate method (or combination of methods). There is considerably more analysis involved when using this option. The appraiser performs an in-depth analysis of the company's financials, makes any necessary adjustments to normalize operations, interviews key employees and gains an understanding of the company's industry, among other things. The result is an independent and comprehensive analysis of the value of the business. Since judgment and subjectivity are involved, there is always the risk that one party may not be satisfied with the results and may challenge the inputs and assumptions.

Choosing the right valuation approach is a balancing act for business owners — deciding between cheap and fast versus more expensive, time consuming and more analytical, while at the same time assessing whether the valuation outcome will be fair and reasonable. It is up to the involved parties to assess how each option fits into their goals and circumstances.

Since most business owners are busy managing and trying to grow their businesses, they often treat buy-sell agreements as an afterthought. The thinking is that a buy-sell agreement is something that may or may not be needed in the distant future, but right now there are "bigger fish to fry." As a result, the critical terms of the agreement, such as purchase price, do not command the attention they deserve.

By spending a little time considering the various valuation options when drafting the buy-sell agreement, business owners can avoid the pitfalls of an inappropriate value and the potential conflicts it may cause. ⚖

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