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Valuation in Buy-Sell Agreements

Michael Wildeveld, CEPA, M&AMI, CM&AP, CM&AA, CBI, CBB
michaelw@veldma.com

Veld Mergers & Acquisitions
www.veldma.com
1 Park Plaza, 600
Irvine, CA 92614
310-652-8066

In the area of buy-sell agreements, we often talk about what those agreements are, what transfer events they cover, why these agreements should be updated as shareholders and companies grow and change, and why the choices you've made about whether buyouts are mandatory or optional may change over time. In this article, we'll discuss the all-important issue of valuation: the pros and cons of using three common valuation methods.

Before we talk about three common valuation methods, there's one critical ground rule that you should know: The valuation method used should be consistent with IRS rulings and guidelines. If the IRS disputes the value used, you or the other co-owner may end up paying more taxes, although that value still governs the price paid for the stock. As you might imagine, that is generally not a result that favors the taxpayer.

A second issue is not so much a ground rule as it is a lesson from experience. As difficult as it may be to decide the valuation method your agreement will use in all transfer events, think how difficult it would be to agree after that event has occurred—the buyer will naturally want the lowest value and the seller the highest value. This conflict can all too easily result in anger, legal expense, valuation expense, etc.

In the world of buy-sell agreements there are three common valuation methods: an arbitrarily agreed upon value, a formula and a fair market valuation (to be performed at the time of the transfer).

Set Value

Some companies (especially in the early years when the prospect of hiring a business appraiser is financially daunting) decide to estimate a value for the company. For example, two shareholders may estimate that the company will be valued at $100,000 should any transfer event occur. This methodology is simple and inexpensive; it works when the estimated amount agreed upon is one the remaining shareholder(s) could raise, if necessary, to buy out a departing owner. Seldom is this method fair to all parties when the business ownership interest is valuable; nor is it one the IRS is likely to embrace! It is typically used when: 1) business value is minimal; and 2) the triggering event is a) funded by life insurance

or b) small enough that the ownership interest payout can easily be funded through future business cash flow (for example, a minority owner with only a 10 percent share cashes out). This valuation approach may be “better than nothing” in the early years of a business, but a successful business is likely to soon outgrow it.

Formula

The second common valuation method is using a pre-established formula to determine the value of the company should a transfer event occur. Formulas are as varied as the companies that create them, but they generally fall into three categories: book value at the time of transfer, some multiple of cash flow (or EBITDA) or a combination of the two.

The formula approach is relatively straightforward and inexpensive to use — as opposed to one requiring a business appraisal. A primary disadvantage can be that the IRS may not be bound to accept the value — even if pre-stated in the buy-sell agreement. In addition, rapidly changing circumstances, in or outside of the business, which dramatically affect value are not “built in” to the formula. As a result, depending on the circumstance, either the buyer or the seller can be disadvantaged (one paying too much or one receiving too little) if a trigger event occurs requiring a purchase and sale.

Fair Market Value

The last common valuation method is to require the use of a certified business appraiser, at the time a transfer occurs, to establish a Fair Value for the company using valuation standards and procedures stated in the buy-sell agreement.

Many business owners prefer this method over the others because it is fair both to the seller and to the buyer of the stock. By capturing the value of the company at the time of the transfer, buyers don’t overpay and sellers get what they deserve.

Terms

No matter the type of valuation method you choose for your company, you will also have to decide the terms of payment. You and your co-owners will decide how much time the buyer will have to purchase stock and what down payment will be necessary. You may decide that buyers will have to personally guarantee unpaid amounts. Will those unpaid amounts carry a minimal interest rate, the prime rate or the rate the company is charged by its bank? What penalties will be imposed for late or non-payment? All of these terms should be clearly stated on a sample promissory note attached as an exhibit to the buy-sell agreement.

In the beginning of a business’s life, few think of leaving; things are simple and your buy-sell reflects that simplicity. As the business becomes valuable, shareholders broaden their interests beyond the business (working less or even leaving it) and ownership becomes complex, your buy-sell agreement should reflect these new and quickly changing realities. Don’t ignore your buy-sell agreement until the day you need it. If

you do, the headaches, the heartache and, very possibly, the legal fees, may be more than you could ever have imagined.

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