

# VALUATION observations



---

## Buy-Sell Agreements: Is Your Purchase Price a Looming Nightmare?

---

*By Kelly C. Noll, CFA  
and Brian D. Bornino, CPA/ABV, CFA*

Buy-sell agreements are among the most common business agreements, and yet many are destined to fail to operate like the owners expect. Many owners remain unaware of the problem until a triggering event exposes the inadequacies of a poorly-constructed agreement. Such inadequacies often result in an unexpected redemption price and/or difficult negotiations between the remaining owners and the exiting owner. A carefully drafted buy-sell agreement can facilitate the transfer of ownership interests at a price and terms that are equitable to all parties involved and operate as the owners originally intended.

Arguably, one of the most important aspects of a well-constructed buy-sell agreement is the provision for the purchase price. The purchase price is typically set in one of three ways: a fixed price, a formula, or a process. Each approach has its own advantages and disadvantages, with some leaving more room for ambiguity and disagreement than others.

### ***Fixed Price Agreement***

This scenario is the most simplistic from a construction and negotiation perspective; that is, the partners simply agree on a price for the business and agree to update it regularly. Unfortunately, most fixed price agreements generally bear little relation to fair market value and are rarely updated; thus, inequities are almost certain to occur as a result of out-of-date fixed price agreements. Further, while it's relatively easy to set an initial price, it is much more difficult to agree on a value as time passes and interests diverge. The longer the period of time between updates to fixed price agreements, the greater the potential for a divergence of interests of the various parties.

*The purchase price is typically set in one of three ways: a fixed price, a formula, or a process.*

### ***Formula Agreement***

In this scenario, the owners determine a formula to calculate price. While seemingly straightforward, formula prices designed without the input of a valuation advisor generally bear little relation to fair market value. Further, there is no single formula that will provide a reasonable price over time, particularly over periods of years. For example, a common formula

*(Continued on page 2)*

---

## Buy-Sell Agreements: Is Your Purchase Price a Looming Nightmare? (continued)

price agreement might be “5 times the most recent year EBITDA (earnings before interest, taxes, depreciation, and amortization)”, but questions soon arise upon a triggering event - are add-backs for non-recurring or unusual events considered? What about excess owner’s compensation? Do we subtract debt? Do minority or marketability discounts apply? What if the company’s business operations have evolved (e.g., perhaps from a manufacturer to a distributor) to where the specified EBITDA multiple is no longer relevant? And the list goes on and on...

Another common formula bases price on the book value of the company’s equity. However, choosing “book value” will generally result in a price significantly less than would result had a different valuation formula been used because, among other weaknesses, book value does not include intangible value (such as goodwill or intellectual property) and does not reflect the future earning potential of the business.

**...Don’t forget about the tax liability!**

Fixed price agreements and formula agreements can also create unexpected tax consequences when the buy-sell agreement provides for a price below the fair market value of the interest. For example, if the triggering

event involves the death of a shareholder, federal estate tax is levied on the fair market value of the stock, which may differ from the selling price under a fixed price or formula agreement. Such inadequacies often result in unexpected taxes and/or difficult negotiations among the remaining owner and the estate of the deceased owner.

**Process Agreement**

In this scenario, the owners agree to let business appraisers set the purchase price after a triggering event. Having an independent expert determine the value of the interest alleviates the bias of owners, although the seller inevitably thinks the value is too low and the buyer thinks the value is too high!

Process agreements can provide for a multiple or single appraiser scenario. In the multiple appraiser scenario (most common), one side selects an appraiser and the other selects an appraiser. If these values are not near each other (which they oftentimes aren’t), the two appraisers typically either select a third appraiser or negotiate based on the first two appraisal reports. While this method can be an

attractive choice because all parties believe that someone is working on their behalf throughout the process, it also creates shareholder incentives

*Fixed price agreements and formula agreements can also create unexpected tax consequences when the buy-sell agreement provides for a price below the fair market value of the interest.*

*(Continued on page 3)*

---

## Buy-Sell Agreements: Is Your Purchase Price a Looming Nightmare? (continued)

---

to select biased, “hired-gun” valuers that develop unreasonable valuation opinions, which often leads to disputes and expensive litigation.


In a single appraisal scenario, both parties agree to select a single independent appraiser. In a best case scenario, the selection of the appraiser is done well before the triggering event. This way, all parties feel they have a say in the selection of the appraiser and can voice any fears of bias at the onset.

Further, it is recommended that the appraiser conduct an initial appraisal of the business to form a basis of value. The initial appraisal should involve a detailed analysis of the specific factors which are most influential in determining a company’s value. Therefore, because the process is observed at the onset, all parties have a better idea of what will happen when the triggering event occurs. Further, subsequent appraisals, either annually or at triggering events, should be less time-consuming for the appraiser and therefore less expensive for the company. Lastly, if the valuation is updated regularly, all parties will have a good understanding of the valuation process, thus limiting the potential for disagreements, surprises, or costly legal battles.

### ***Our Take: It All Starts with the Agreement***

The all-too-common issues described in this article illustrate the importance of crafting a buy-sell agreement that unambiguously reflects the parties’ intent and establishes an equitable value. Too often, when a fixed-price or formula agreement is included in the buy-sell agreement, by the time a triggering event occurs, the resulting price rarely bears resemblance to fair market value. On the contrary, regularly

*Too often, when a fixed-price or formula agreement is included in the buy-sell agreement, by the time a triggering event occurs, the resulting price rarely bears resemblance to fair market value.*

updating an appraisal using a process agreement assures a current value in the buy-sell agreement and enables shareholders to monitor their wealth in the closely held business. Professionals at GBQ have valued many businesses in connection with a buy-sell agreement or similar transaction event. Please give us a call to discuss a specific situation in confidence. 

### ***Interested in Learning More?***

GBQ is hosting a seminar on ***Buy-Sell Agreements for Privately-Held Businesses***. Join us at our Columbus office on December 10, 2010 as we discuss:

- Your corporate buy-sell agreement: is it set up to fail?

*(Continued on page 4)*

---

## Buy-Sell Agreements: Is Your Purchase Price a Looming Nightmare? (continued)

---

- Why EVERY business should have a buy-sell agreement.
  - Are you SURE you know what your purchase price says? How will it be interpreted by appraisers and the courts?
  - Consequences for buy-sell provisions written below fair market value.
  - How the treatment of life insurance proceeds and other factors can make a big difference in the valuation of your company.
  - Nightmares of buy-sell agreements: stories from the war chest...is yours next?
- [cevens@gbq.com](mailto:cevens@gbq.com) or 614-221-1120.

For more information or to register, please contact Christina Evans at

### ABOUT US

GBQ Consulting specializes in Business Valuation, Mergers and Acquisitions, and Dispute Advisory and Forensic Services. Our Business Valuation group is one of the largest and most experienced in the Midwest. Professionals at our offices in Columbus (OH) and Indianapolis (IN) provide the following services:

- Transaction Support & Opinions
- ESOP & ERISA Advisory
- Succession & Wealth Planning
- Financial Reporting Services
- Corporate Planning & Assistance
- Expert Opinion Valuations

### CONTACT

**Brian D. Bornino, CPA/ABV, CFA, CBA**  
Director of Valuation Services  
[bbornino@gbq.com](mailto:bbornino@gbq.com)  
614.947.5412

**Shaun P. Duffin, CPA/ABV, ASA**  
Manager  
[sduffin@gbqgoelzer.com](mailto:sduffin@gbqgoelzer.com)  
317.423.0150

**Kelly C. Noll, CFA**  
Senior Financial Analyst  
[knoll@gbq.com](mailto:knoll@gbq.com)  
614.947.5227

**Visit our websites**  
[www.gbqconsulting.com](http://www.gbqconsulting.com)  
[www.gbqgoelzer.com](http://www.gbqgoelzer.com)