

BV Landmines in Buy-Sell Agreements

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Well written buy-sell agreements, whether stand-alone shareholder agreements or incorporated in partnership and operating agreements, facilitate business transitions even in the worst of times and are a crucial component of business planning. A poorly structured agreement complicates execution and leads to the very disputes it was intended to eliminate. Disputes related to the value of equity interests are some of the landmines that get into the way of a smooth transition. We have some thoughts on that issue.

Avoid stated values. The true value of business interests changes continually over time. In stated value agreements that contemplate periodic, often annual, updates of the owners' stated value, rarely is value updated. So the last, often original stated value holds. That is frequently catastrophic since the true value of a transferor's business interest will almost always vary materially from an early stated value, leaving him or her or their heirs empty handed. Ouch!

And by the way, how did the owners know what the value was originally without engaging a qualified appraiser to guide them? The same issue arises with annual updates. The need for serial appraisals makes the use of stated value expensive, and in a real sense, not practical.

Value formulas can be just as meaningless. The formula selected (i.e. "2 times book value", or "1 times revenue", or "3 times EBITDA") may not have properly valued a business interest at the outset. Over time the usefulness of any particular value metric can change, creating even more variance between formula results and true value. And at any specific measurement date the formula may miss-value of a person's interest simply because of unique circumstances that are temporarily distorted by the chosen metric.

Even the most cautiously constructed buy-sell agreement needs to be reviewed continuously to reflect the changing business circumstances. In a recent matter where the parties decided on a valuation based upon adjusted net assets, the parties carefully defined those assets which were to be revalued based upon market values; all other assets were to be valued based upon Generally Accepted Accounting Principles. The agreement was nearly two decades old, and at the time the company held no real estate. Two years after signing the agreement, real estate was purchased, but the agreement was never updated to reflect the need to value it at market value. The value of the real estate doubled over time, but the agreement continued to require a GAAP valuation.

One of the best, and cost effective solutions is to engage a qualified business appraiser to value an interest when a transition need arises, whether that is simply a desire for liquidity (i.e., "I'm leaving!"), death, disability, or retirement. There may be times throughout ownership where periodic appraisals might be engaged – adequacy of life insurance (especially important if a buyout is funded by insurance), value enhancement measurement, gift or estate planning, or portfolio management.

If agreements ignore stated values and formula values, reliance is then often placed on more traditional forms of determining value. But defining the type of value sought, or the Standard of Value, is often overlooked or stated in error, needlessly making adversaries out of business

partners. The Fair Market Value (FMV) Standard of Value is often chosen, but this defines the cash value of the interest to the hypothetical seller and buyer. FMV is a well-established valuation concept, with extensive authoritative literature available to parties to the agreements. But keep in mind that FMV assumes that adjustments for control, liquidity, and marketability will apply. Therefore the heirs of a person who enters a business one day by funding and taking a 25% interest, but dies a week later, may only receive 10% or 20% of the value of the whole business because of the adjustments. There is nothing wrong with this as long as all parties understood the implications going in. If the parties' goal is that each should receive his or her pro-rata, undiscounted share of the enterprise, and if they wish to define it as Fair Market Value, the wording must reflect that the apportionment must be based upon "the proportionate share of the Fair Market Value of the enterprise" rather than "the Fair Market Value of the proportionate share of the enterprise." Careful drafting avoids big problems.

One alternative Standard of Value is often called Fair Value (FV). But FV must be defined in each case; there is no generally prescribed value definition. FV might be defined as FMV with no equity-holder-level adjustments for control, liquidity, and marketability. The interest holder is thus entitled to his or her ownership percentage of the value of the business as a whole. The statutes in many states effectively use this or a similar definition when shareholder disputes or derivative actions are brought to it. However the concept may differ materially from state-to-state.

Most agreements adequately define triggers for the buy-sell enforcement, but the measurement dates can be a concern. In an ideal world, the measurement date should be the last accounting cut-off date prior to the trigger where the company has adequately closed out its business affairs and reported financial position and trailing twelve month operating results. "Adequately" means that the accounting staff is trained and sufficiently sophisticated to make necessary adjustments often required at a close date, and competently prepare financial statements. At a minimum that means the prior year-end when all businesses are forced to close out affairs to file tax returns. But with the advent of accounting technology, businesses are often able to competently report financial position and TTM operating results monthly. The attorney needs to inquire about the competency of financial reporting to guide the client in selecting a reasonable measurement date.

"The market value shall be determined by the company's independent certified public accountant, whose sole opinion shall be binding upon the parties to this agreement." Fifty years ago, this was not an unusual way to define value and the person whose judgment would be relied upon. But "market value" cannot be defined and applied rationally when parties to an agreement have adverse interests. And who is to say that the company's CPA, regardless of his or her training, financial acumen, and skill in accounting and tax and knowledge of the client, is qualified to render an opinion of value?

Opinions of value need to be determined based on appraisals performed by qualified business appraisers. These people are credentialed by one or more of the half dozen appraisal associations. The appraiser's work must conform to the Uniform Standards of Professional Appraisal Practice, as well as the various standards of the credentialing organizations to which they belong. Candidly, the standards of the various credentialing organizations are very similar today. Agreements should define a qualified appraiser as one who has earned credentials from one or more of the appraisal associations. By the way, CPAs have often earned appraisal credentials, but in order to avoid a conflict of interest, and to add professional objectivity, the

appraiser should not be the person or company that handles the company's accounting and tax services.

Do we use one appraiser or an army? Business appraisals are costly and time consuming. The use of one appraiser is ideal if the parties can agree on one person and the use those results. This requires a level of comfort among the parties that is often lacking. An agreement might offer the buyer and seller the ability to select one appraiser, but have a fallback to allow each to select their own, with the results averaged. Attorneys will then worry, "what happens if the results of each are far off?" Although materially adding to complexity and cost, if the value variance is greater than, say, 25%, the agreement could require the engagement of a third qualified appraiser to resolve the variance of the other two either through critique, negotiation, or even a third appraisal based on the information presented by the original two appraisers. Obviously, the bigger, more valuable, and more complex the company, the greater the need for, and ability to, afford multiple appraisals.

Here's an important piece of advice. Ask a qualified independent appraiser to review the valuation section of a proposed buy-sell agreement to determine whether the structure properly defines the appraisal study and outcome. If you have clients with existing agreements, it would be well worth having an appraiser review the structure of the appraisal study and implied outcome to see whether the process can be executed without dispute among the parties. After all, that was the intention of the agreement.



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CV-ABA is a multi-office financial services firm offering appraisal, litigation support, and M&A services throughout the US from its offices in Atlanta, Raleigh, and Wilmington.