

Buy-Sell “Agreements”: A Misnomer?
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The purpose of a buy-sell agreement is to allow for a relatively easy business transition from one shareholder to another. However over the past few years, we have read a few agreements which might be better referred to as Buy-Sell Disagreements. The agreements contained incorrect and/or confusing language. Given these problems, there is little wonder that these transactions ended up in litigation where business transitions are never easy.

In the examples below, these “agreements” morphed into subjective interpretations of “value” – their exact opposite intent – and/or resulted in “values” significantly different than existing market conditions. Unfortunately for the companies involved, it may have been less subjective and less costly for the agreements to merely read that an appraiser(s) will determine fair market value (FMV) as of a particular date.

Buy-Sell #1:

“Fair Market Value of the Company” shall mean the average of the following three valuation methodologies with respect to the Company, each as determined by the Company’s regular accountant: (1) capitalization of earnings (weighted average), (2) capitalization of earnings (latest year’s earnings) and (3) discounted cash flow.

First, the definition of FMV above does not fit any definition of FMV we have encountered before. Are we using a formula, or are we determining FMV? Thus, do we abandon guidance on the use of the three approaches and calculate FMV in accordance with the standard FMV definition? Or since it is obvious that the intent of the language was for the appraiser to use the three approaches above, should the appraiser just ignore the term FMV?

Second and more importantly, how does one employ the weighted average capitalization of earnings method? How many years should one look at? Since the second method is also a capitalization of the latest year’s earnings, should the “appraiser” also include the latest year’s earnings in the first method? If so, how much should we weight the second approach? Or should the appraiser just use it under the second method? Why the redundancy in the first two approaches?

Moreover, what earnings should we capitalize? Do we normalize earnings, or not? Does the fact that the agreement mentions the company's regular accountant, who may or may not be qualified to render appraisals, preclude the use of a qualified appraiser who is not the company's regular accountant?

Buy-Sell #2:

The books and records of the Company shall be kept on a tax basis of accounting in accordance with generally accepted accounting principles.

Since generally accepted accounting principles are based on the accrual method of accounting, this requirement is especially difficult to abide by. Should the appraiser use financial statements prepared under tax accounting or accrual accounting when using the formula?

Buy-Sell #3:

The term "fair market value" of the member's percentage of ownership interest shall be determined as follows:

(A) The Company shall be valued annually as to the fiscal year end by a certified valuation analyst. The value established by the analysis shall be binding upon all Members or Member shareholders for twelve (12) months or until the next valuation, whichever comes first.

The withdrawing Member will be paid its capital account and its ownership interest at the expiration of the first five years, without interest, regardless of the day of withdrawal.

If one only looks at these instructions, the member shall receive his or her book value (capital account) and the FMV of his or her interest, which will necessarily incorporate goodwill (see below). Isn't this an incredible deal for the withdrawing member, since the member receives his or her interest's book value plus its FMV?

Furthermore, even though the agreement called for FMV, there was disagreement as to whether discounts should be taken for lack of control and lack of marketability for the minority interest in question. If discounts are a company's intentions, then it is probably best to state that they should be

considered. If discounts are not required, then state that also but do not call for a fair market value valuation.

Omission of Provision for Goodwill. The omission of any provision in this paragraph for a valuation of Company goodwill is deliberate. Each Member waives its right to receive payment, in the event of its termination as a Member, of any amount for its interest in goodwill of the Company.

Before you believe that this last paragraph supersedes anything written above we will tell you that this was the primary reason behind the lawsuit – should goodwill be included or not? One has to admit that even though the language is explicit in the last paragraph, when compared to the paragraph before, there is significant confusion – an unfortunate result.

In summary, it is crucial that corporate attorneys and business owners consult with appraisers in drafting Buy-Sell documents to ensure they become agreements and not disagreements.

We recommend that business owners and corporate attorneys consult with appraisers to perform a sensitivity analysis on any formulas, looking for potential subjective areas of interpretation. Appraisers must carefully assess each word individually, and in aggregate, to ensure the agreement is well-crafted, explicit, detailed, and irrefutable – to the extent that it is possible in business valuation - to avoid costly unintended consequences.

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