

# AVOIDING COSTLY PITFALLS IN BUY-SELL AGREEMENTS

by Royce Stutzman

Listen to this conversation: “*But this value is not fair! I know that the agreement says four times the average of the last two years’ EBITDA, but there were several one-time costs that will not happen in the future. It’s not fair!*”

Could this happen? Yes, and from my experience, it does. Let’s look at some of the frequent pitfalls in buy-sell agreements that can happen and, with proper drafting, can be avoided.

Some of the different types of buy-sell agreements are *fixed-price*, *formula*, and *process*. Fixed-price and formula buy-sell agreements are generally easy to understand and to negotiate – the first time only. They tend to be easy for attorneys to draft and no business valuation expert is required.

The pitfalls in these agreements are numerous. A *fixed-price* buy-sell agreement is out of date when inked. The price is seldom updated, even after many years have passed, and frequently the price is not even looked at until a triggering event.

A *formula* buy-sell agreement is usually set based on the state of the economy and the company’s industry at the time it is drafted. However, changes occur that can impact the true value relative to any set formula. In addition, formula buy-sell agreements are fraught with definitional issues. They are based on historical numbers, do not allow for unusual, one-time events, and can be subject to multiple interpretations.

*Process* buy-sell agreements are more complicated and therefore subject to even more pitfalls. A process buy-sell agreement calls for one or more business appraisers to determine the value in a manner defined in the buy-sell agreement. This raises the following two questions: How do appraisers determine value? Is the wording in the agreement unclear, leaving room for appraisers’ interpretation?

Let’s look at potential pitfalls of process buy-sell agreements by reviewing the six defining elements of process buy-sell agreements: standard of value, level of value, “as of” date, qualifications of appraisers, valuation standards and funding mechanism.

Every valuation is defined in part by the *standard of value*. The agreement should specifically say what the standard is. There are several types, including fair market value, fair value, investment value, going concern value,



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and liquidation value. The fair market value standard is generally understood to follow the IRS definition. If the agreement calls for any other standard of value, the words on the page must be crystal clear.

It is critical to be clear about the *level of value*. If the business is to be valued on a strategic control value, it will be very different from a financial control value. Then the question is: Does the appraiser consider marketable or nonmarketable minority levels of value?

Here’s an example of two appraisers valuing the same company, but interpreting the ambiguous language in the agreement differently. Both started out with the same \$100 per share for a financial control marketable minority value. Then the following differences in interpretation developed, which both appraisers could find language in the agreement to support. The company appraiser decided that a 40% marketability discount should be applied, resulting in a price per share of \$60. However, the appraiser representing the shareholder decided that the appropriate level of value was strategic control value, and applied a control premium of 40%, resulting in a value per share of \$140. Now there are two very different results, based on an agreement that was not clear, causing the appraisers to decide for themselves what each thought the agreement said.

The “*as of*” date is also critical to the appraisal process. This date establishes the time for valuation. However, there are other business issues that ought to be considered but that are frequently left open, such as rights after death, if any, including rights to receive the price in the agreement; voting and distribution; and other ownership interests in the business.

It is also important that the buy-sell agreement specifies the *qualifications of the appraiser* and the application of professional *valuation standards*. There are several terms that are used in agreements, including “appraiser,” “qualified appraiser,” “licensed general appraiser,” “investment banker,” and “accountant.” Are all appraisers alike? No. Make sure your buy-sell agreement calls for qualified and credentialed business appraisers to ensure that you receive the most accurate, well-informed appraisal. Credentialed business appraisers are bound by one or more of the following business valuation standards: Uniform Standards of Professional Appraisal Practices (USPAP), American

Institute of Certified Public Accountants (AICPA) Business Valuation Standards, as well as standards of the National Association of Certified Valuation Analysts (NACVA), the American Society of Appraisers (ASA), and the Institute of Business Appraisers (IBA).

If the buy-sell agreement calls for a *funding mechanism* that involves some kind of insurance, specifying the intent of the insurance as a funding agreement or a corporate asset is key. If it is a funding vehicle, the resulting value to the departing shareholder could be considerably less than if the insurance is treated as a corporate asset.

So how can you be sure that your agreement results in equity and fairness to all parties? Here's how: ask a qualified appraiser to prepare a valuation based upon the agreement in place. In the process, ask the appraiser to identify any areas where the agreement could be interpreted differently and what the difference in value would be.

This approach will enable you to:

- Know the value now
- Understand the process
- Identify any issues regarding unclear valuation-defining terms and allow you to make changes before a triggering event
- Help the parties involved gain confidence in the process and know the value for other purposes, such as estate planning, insurance needs, etc.

The best approach to ensure an effective buy-sell agreement and avoid costly pitfalls is to ask a single qualified, credentialed appraiser to value the business, and to value it regularly. This will ensure that when a triggering event does occur, your client's buy-sell agreement will be interpreted clearly for fair results.

*Royce Stutzman, CPA/ABV, CVA is Chairman and leader of the Valuation Group at Vicenti, Lloyd & Stutzman, a 57-year CPA and business consulting firm in Glendora. Royce, a frequent speaker, will soon lead a webinar on effective buy-sell agreements. For more information, please contact Royce at (626) 857-7300 or at RStutzman@vlsllp.com.*



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