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Advanced Markets

Think about it

What every financial professional needs to know about reviewing buy-sell agreements: Part two

Business valuation

If the purpose of a buy-sell agreement is to establish a peaceful process for transfer of the business, then perhaps valuation of the business interest is the most critical issue covered by the agreement.

Appraisal

The appraisal method of valuation means the buy-sell agreement avoids specifying a price for the business in the event of a triggering event. Instead, the agreement sets forth a process by which the assets of the business — or the entire business — will be valued in the future.

The buy-sell agreement might provide, for example, that at the death of one of the owners, the buyer or buyers will hire an appraiser for the business, and the seller's heirs will hire their own appraiser. The appraisers will each come up with an independent valuation for the business. If their valuations do not agree, the appraisers will get together to nominate a third appraiser to act as a kind of arbitrator for the valuation process.

While using the appraisal method for valuation is better than having no valuation method at all, for most businesses it's not the recommended path. The appraisal method really puts off the hard questions until later, at a time when it's usually more difficult to decide peacefully what a business is worth. And it's expensive.

Here are some potential issues. If the agreement requires two appraisers to agree on a business value, what if one appraiser wants to use a book value calculation and the other wants to base valuation on the company's earnings? If both agree to use earnings as the method to determine value, should excess officer earnings be taken into account? What interest discount rate should be employed? And, if the appraisers don't agree on the company's value, what if they also can't agree on a third party to arbitrate?

Part two

This is the second of a two-part *Think About It* series on reviewing buy-sell agreements. This issue discusses valuation issues and special buy-sell concerns. It also includes a formal sample checklist the non-attorney professional can use in reviewing the buy-sell agreements of business owner clients.

Please review last month's issue for an overview of buy-sell planning, a description of buy-sell structures and thoughts about the types of triggering events that may be included in buy-sell agreements.

If the parties insist on putting off valuation until a triggering event occurs, it can facilitate the valuation process if the buy-sell agreement provides firm direction with regard to:

- Valuation methodology
- Source of business financial figures
- Valuation expert or experts who must be used

In most cases the parties are better served if they agree to a fixed price or, even better, a valuation formula and set the fixed price or set up the formula at the time the buy-sell agreement is drafted or updated.

Fixed price

The parties to a buy-sell agreement might fix a price for the buyout in the event a trigger occurs. For example, the owners of a two-equal-shareholder corporation might agree that the value of the entire business is $1,000,000. In the event one of them dies, the buyout price will be $500,000.

The fixed-price valuation creates certainty for the owners, allowing them to make sensible financial plans for the transfer and continuation of the business. And it's simple and easy for all of the parties to understand and use for planning purposes.

The biggest potential drawback of a fixed-price agreement is the danger that the price will become "stale." Say that in our two-owner corporation described above, the parties do not update their buy-sell agreement for 5 or even 10 years. Assume also that business sales grow substantially over that time. If one of the owners dies, is the buy-sell agreement legally enforceable? Would it be fair for the surviving owner to force the decedent's heirs to sell at the stale price? Would the IRS or a court give any credibility to the fixed price if the agreement was more than, say, 10 years old?

While most fixed-price agreements include terms that allow the parties to update the buyout price on a regular basis, as a practical matter the owners of a business often neglect the task. The possibility that the owners of a company will fail to update a fixed-price agreement can be managed with solutions in the buy-sell agreement. However, we suggest most owners consider a more flexible valuation method, one that has a chance to mirror the actual value of the business over time.

Formula

The formula valuation method is a more flexible way to set a buyout price for an ownership interest than the fixed-price method. These are examples of formulas that might be used to value an entire business:

- Balance sheet assets minus liabilities plus one-half of accumulated depreciation.
- One and one-half times the business's gross sales for the preceding 12 months.
- Seven times the average net profit of the business for the preceding 3 calendar years.
- Five times the aggregate average annual cash flow to the owners for the prior calendar year.
- Two times accounts receivable on the date of sale.

So which one is correct?
The truth is that any one of the formulas may be correct for a given business, or none may be an accurate fit. The owners of a business may agree to any formula they believe will fairly reflect the value of the company now and in the future. Having the owners agree on a formula at the beginning is the hard part, but setting the buyout price in advance maximizes the chances for a smooth transition later.

Special valuation issues with family businesses

Family businesses create their own sets of continuation issues. Family dynamics, estate tax issues and competing points of view all contribute to the buy-sell quagmire.

Here's an example. Say that Todd originally created the First Insurance Agency, Inc., and that he is currently the 100% owner. The agency's fair value is about $15,000,000.

Todd's son, Rob has been working in the agency for 10 years. Todd's wife, Rita, who is Rob's stepmother, also works at the agency. Rob and Rita really don't get along. Todd also has two other children, Jack and Marilyn, who do not work at the business.

Without a buy-sell agreement, it is difficult to see how the family would continue the business after Todd's death. However, even with an agreement, the family needs to pay special attention to valuation provisions.

The tax code imposes special requirements on a family business if the buy-sell agreement is intended to fix the value of the business for estate tax purposes. Section 2703 of the Code imposes a three-part test for family-owned businesses:

1. The buy-sell must be a bona fide agreement.
2. The buy-sell must not be a device to transfer the business for less than a fair price.
3. The terms of the buy-sell must be comparable to those entered into by unrelated parties.

Why is a convincing value important? Remember in the family buy-sell example above, we assumed that the insurance business was worth $15,000,000. An asset of that size would create tax issues for Todd's estate at his death. Further, if the estate and the IRS disagree about the value of the company, there's a potential for a costly fight with the service over valuation.

What steps should a family business take to avoid the special valuation issues? The following suggestions should be considered:

1. Implement a fixed price or formula agreement.
2. Substantiate the initial buyout price with a formal appraisal by a qualified independent professional who is familiar with valuation practices of similar businesses.
3. Review and update the agreement on a regular basis to make sure the buyout price does not become outdated.

Valuation – Estate tax issues

Even with nonfamily businesses a death-time buy-sell trigger may create estate-tax issues. Treasury Regulation Section 20.2031-2(h) imposes valuation rules for buy-sell agreements between unrelated parties. If the owners want to fix the value of a business interest for estate-tax purposes, the decedent must not have been free to dispose of the stock at other than the contract price during his lifetime.

Four further requirements are imposed as a prerequisite to convincing the IRS that the value in the buy-sell fixes the value of the business interest:

1. The price was fixed or determinable.
2. The estate of the decedent was obligated to sell.
3. The agreement contained restrictions on the decedent's ability to make a lifetime transfer.
4. There was a valid business purpose for the agreement.

The second requirement, the obligation to sell, means an optional buy-sell — one that gives the buyer or buyers an option to purchase at death instead of requiring a purchase — will not fix the value of the business for estate-tax purposes. That fact is another reason successful business owners should generally choose mandatory buy-sell agreements.

Special concerns

A comprehensive review of a buy-sell agreement needs to include evaluation of other items.

Appropriate funding mechanisms

Even the best buy-sell agreement can fail if its funding mechanisms are not well thought out. The parties should consider appropriate funding for each included trigger.

Death is usually the easiest trigger to fund for, if adequate insurance is purchased on the lives of the parties to the buy-sell agreement. What if insurance is not available at a reasonable price? What if the amount of the insurance is less than the buyout price? What if one of the insurance policies does not pay a death benefit, perhaps due to a suicide or failure to pay a premium?

Often the parties consider purchasing disability buyout insurance to cover the funding for a disability trigger. The expense of that insurance is usually high compared to life insurance.

What if the parties still want to have a disability buyout trigger but can't or won't buy an adequate amount of disability buyout coverage?

And what about triggers for which insurance won't work? Properly drafted buy-sell agreements should have contingency plans in effect for the possibility that insurance fails or is otherwise unavailable. Since most businesses — or their owners — can't afford to come up with a lump-sum payment in the event of a trigger, the backup plan usually means the business or owners of the company will purchase the relevant business interest over time.

The buyout over time generally employs the use of a promissory note structure. For example, if Bob is supposed to buy out Ray's business interest for $1,000,000, they might structure the buy-sell so that Bob pays Ray in monthly installments. At the time the buyout is triggered, the seller — Ray in this case — is probably more interested in a shorter installment period and higher interest rate, while the buyer — Bob — likely wants a longer term and lower rate. Anticipating the possible conflict at buyout, the parties should settle the amortization rate, term, down payment and frequency of payments in the buy-sell agreement.

Employment vs. ownership

Some business owners fall in love with the idea of bringing one or more of their key employees into ownership of the business. For those cases where employee ownership makes sense, the parties might consider an ESOP, or nonqualified ownership buy-in by the employee. However, owners of closely held businesses often share a key character trait — the desire to maintain absolute control. This is particularly true if the owner of the business is one person.

If an owner of a business really wants to maintain complete control of that company, sometimes it's not in the owner's best interest to bring in one or more key people as owners. That's because owners — even minority owners — may have some legal say in the operation of the company and at the least have the legal right to obtain information and question certain actions taken by the majority owner.

The 100% owner of a closely held business may still believe he should transfer at least some ownership of the business to a key person. Perhaps the motivation for creating a minority owner would be for a redemption buy-sell agreement to work properly. The majority owner may see making a key person a minority owner as a way to have the key person more invested in positive corporate financial results.

Bringing a minority owner into the business is not something an owner should do without extremely careful consideration. Most business objectives, including ensuring the proper function of a redemption buy-sell agreement or inducing profitable behavior, can usually be achieved without transfer of ownership interests.

Proper parties

Say that Bob, Carol, Ted and Alice are equal owners of a trucking company. Carol is married to Bob, and Ted is married to Alice. Bob and Ted are active in the business while Carol and Alice are not. Bob and Ted want to enter into a cross-purchase buy-sell agreement, which will transfer the entire business to the survivor of the two of them if either of them passes.

Who are the proper parties to the agreement?

In the preceding example all four owners would need to be parties to the agreement, as the objective is for each to have obligations in the event of Bob or Ted's death.

Unfortunately, not every buy-sell agreement includes all the right parties. Check to make sure everyone who should be included is included.

Issues with multiple businesses

Here's another relatively common example that underlines the special issues associated with coordinating the buy-sell agreements of multiple related entities.

Assume that Sam, Ben and Molly are attorney-entrepreneurs who share office space and administrative staff. Sam and Ben each have professional corporations in which they are employees, while Molly runs her practice as a sole proprietor. All three lawyers are shareholders in a corporation which employs the administrative staff.

Each attorney's business pays a monthly amount to the corporation in exchange for the services provided. Ben and Molly each personally own 50% of the building where the practices are located.

Finally, Ben also operates a mortgage lending business out of the same building, which is organized as a single-member LLC.

The mixed ownership arrangements probably don't conform easily to a single buy-sell agreement. The parties might end up with multiple documents along the following lines:

- Sam enters into a one-way buy-sell agreement with Ben and Molly, under which they agree to buy his professional corporation in the event of Sam's death.
- Ben and Molly each enter into agreements with the other lawyers with the same one-way buy-sell provisions.
- The three attorney-owners of the operating corporation implement a separate buy-sell agreement for that company.
- Ben and Molly create a buy-sell agreement for their real estate partnership.
- Ben agrees to a buyout agreement with Molly for the mortgage LLC if something happens to Ben.
- Finally, the lawyers' companies and the mortgage LLC enter into a lease agreement with Ben and Molly to tie up the loose ends not covered by the buy-sell agreements.

Consistency with operating document

Corporations, LLCs, and partnerships generally have operating documents. These documents create a set of binding rules for how the businesses will operate. In a corporation, the rules are bylaws. For an LLC or partnership, the document is usually referred to as an operating agreement.

If the operating document and buy-sell agreement are inconsistent, it may create a problem for the owners upon a triggering event. For example, the operating document may say that transfers of business interests are not permitted. The buy-sell agreement, on the other hand, may set rules permitting transfers under certain circumstances.

An inconsistency between the documents may create uncertainty about what the parties intended, defeat the intent of the buy-sell agreement, and lead to ugly and expensive litigation. It makes sense that a review of the buy-sell agreement will include a review of the operating document to check for any such inconsistency.

Integration with estate plans and estate taxes

For many entrepreneurs, the interest in one or more closely held businesses represents a substantial portion of their net worth. The business buy-sell plan should integrate with overall estate planning, and the estate taxes associated with the transfer of wealth must be planned for. For the planning professional these items are part of the check-up process.

In addition to the buy-sell agreement, the professional should also pick up copies of any wills, trusts or other estate planning documents that may be relevant to the their clients. The advisor should also have a reliable estimate of the net worth of the parties.

Conclusion

Performing a thorough checkup of a buy-sell agreement can be one of the most important services the planning professional can provide for his business owner client. In this two-part series, we have explored the main parts of typical buy-sell agreements and have identified some of the key provisions that need to be addressed. The information should be helpful as you help your clients review their business continuation plans and also as you coach new prospects through the buy-sell process.

To facilitate your review of your clients' buy-sell agreements, we have included a buy-sell review checklist on the following pages. Feel welcome to use it in service to your clients.

Buy-sell agreement review checklist

Name of business: ____________________

○ Partnership ○ C Corp ○ S Corp ○ Partnership LLC ○ Other: ____________

Owner Name	Percentage Ownership/Number of Shares

Are the owners related? ○ Yes ○ No

Describe: ____________________

Name of related business: ____________________
(use back if more than one)

Buy-sell for related business: ○ Yes ○ Copy obtained

Date of buy-sell agreement: ____________________

Buy-sell agreement matches:

1. Names of current owners ○ Yes ○ No
2. Legal name of business ○ Yes ○ No
3. Current ownership percentages ○ Yes ○ No
4. Required non-owner parties ○ Yes ○ No

Explain "No" answers: ____________________

	Assets	Liabilities	Gross Sales	Net Income
Valuation Information				
Current Year				
Prior Year				
Second Prior Year				

	Current Year	Prior year	Second year
Adjustments to Valuation			
Accumulated Depreciation			
Total Owners' Compensation			
Second Prior Year			

Valuation notes: ____________________

Buy-sell structure: ○ Entity purchase ○ Cross-purchase ○ Wait-and-see ○ One-way

○ Other: ____________________

Buy-sell agreement review checklist, page 2

Death Trigger

○ None ○ Mandatory ○ Optional

Definition: ______

Valuation method: ______

Payment terms: ______

Matches current desire? ○ Yes ○ No

Explain: ______

Disability Trigger

○ None ○ Mandatory ○ Optional

Definition: ______

Valuation method: ______

Payment terms: ______

Matches current desire? ○ Yes ○ No

Explain: ______

Divorce Trigger

○ None ○ Mandatory ○ Optional

Definition: ______

Valuation method: ______

Payment terms: ______

Matches current desire? ○ Yes ○ No

Explain: ______

Bankruptcy Trigger

○ None ○ Mandatory ○ Optional

Definition: ______

Valuation method: ______

Payment terms: ______

Matches current desire? ○ Yes ○ No

Explain: ______

Retirement Trigger

○ None ○ Mandatory ○ Optional

Definition: ______

Valuation method: ______

Payment terms: ______

Matches current desire? ○ Yes ○ No

Explain: ______

Termination for Cause Trigger

○ None ○ Mandatory ○ Optional

Definition: ______

Valuation method: ______

Payment terms: ______

Matches current desire? ○ Yes ○ No

Explain: ______

Buy-sell agreement review checklist, page 3

Other Triggers

○ None ○ Mandatory ○ Optional

Definition: ______________________

Valuation method: ______________________

Payment terms: ______________________

Matches current desire? ○ Yes ○ No

Explain: ______________________

Non-compete Provision

○ Yes ○ No Matches current desire? ○ Yes ○ No

Explain: ______________________

Copies of the following obtained to check for consistency between documents:

○ By-laws or operating agreement ○ Ownership certificates ○ Financing documents ○ Employment agreements

Life insurance policies

Life Company	Type	Owner	Beneficiary	Premium	Sur. Val.	Loan	DB

Disability policies

Company	Type	Owner	Beneficiary	Ann. Premium	Benefit

Co. Attorney Information

Name: ______________________

Phone ______________________

Address: ______________________

Email: ______________________

Co. Accountant Information

Name: ______________________

Phone ______________________

Address: ______________________

Email: ______________________

IMPORTANT INFORMATION:
Policy loans and withdrawals will reduce the cash value and face amount of the policy.
Clients may need to fund higher premiums in later years to keep the policy from lapsing.

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