THE POWER OF BEING UNDERSTOOD

AUDIT | TAX | CONSULTING

RSM

BUY-SELL AGREEMENTS FROM A VALUATION PERSPECTIVE

Zach Eubank, JD, MBA, CVA

April 20, 2018

RSM

Introduction

Zach Eubank

Director

RSM Valuation Services / Des Moines, IA

Business Valuation

zach.eubank@rsmus.com

RSM

BUY-SELL AGREEMENTS

RSM

Purpose of Buy-Sell Agreements

- Protect shareholder and entity in the event of a triggering event
- Determines pricing mechanism to purchase entity shares
- Restrict and allow for transferability
- Estate planning tool
- Preserve S corporation status
- Numerous considerations

Forms

- Free standing buy-sell agreement
- Shareholders' agreement
- Operating agreement
- Partnership agreement

Trigger Events

- Owner quits
- Owner retires
- Owner becomes disabled
- Owner death
- Owner divorce

Fixed Price Agreements

- Agreed on a price in the agreement (per unit, per share, etc.)
- Transactions may occur at a future date between the owners
- Defines triggering events
- Mechanism for updating agreed upon price

Fixed Price Agreements

- Straight forward
- Economical
- Can become outdated very quickly
- Seldom updated on a regular basis
- Competing interests based on owner characteristics
  - Age
  - Health
- Suggest revisiting these agreements if in place with clients

RSM

Formula Agreements

- Agree on a formula to set the price
- Transactions may occur at a future date
- Defines triggering events
- Outlines the formula to be applied
  - Can be several calculations
  - Typically tied to then current financial statements
  - Can be changed but usually the initial formula is price determinative

RSM

Formula Agreements

- Straight forward
  - Multiples of net income; earnings before interest taxes depreciation and amortization ("EBITDA"); book value etc.
- Economical
- Static formulas do not reflect the value of a changing company, industry, economic conditions
- Book value
  - Rarely reflects the true fair market value
- Multiples
  - What level of earnings is appropriate?
  - Do you take an average or weighted average on earnings? Most recent year?
  - What if trigger event multiples are completely different?
  - Was the agreement formed prior to the TCJA?

RSM

Formula Agreements

- Multiples (Cont.)
  - How is debt considered?
  - How are shares/units treated? Diluted? Different classes?
  - Who does the formula calculation? Independent party?
  - Other items on balance sheet? Excess cash? Non-operating assets?
  - If client has formula agreement it may make sense to review and possibly revise if applicable.

Shotgun Agreements

- Upon triggering event one party determines price
- The other party is able to buy or sell at that price
- Somewhat rare
- Can be used to break deadlock situations
- Requires a transaction – parties don't know if they will be the buyer or seller
- Presumes a reasonable price

Shotgun Agreements

- Straight forward
- Economical
- Reasonable price – pressure on initial offering party to come up with something reasonable
- Problems arise with financial capability and business knowledge
  - Surviving spouse may not know about the business
  - It could be difficult for a 30% owner to buy a 70% owner's interest
  - Seller may not want to become a buyer

Valuation Process Agreements

- Can be complex
- Can be expensive
- Agree on process to determine value
- Not based on formula or set price
- Can involve one or more appraisals and appraisers

Valuation Process Agreements

- Agree/decide what appraisers will do in analysis
- Standard of value
  - Type of value
  - Highly important
  - Fair market value?
  - Fair value?
  - Other standard of value?
  - Can deeply affect the outcome

Fair Market Value

Fair market value is defined by Rev Rul 59-60, 1959-1 CB 237 as:

> *The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Court decisions frequently state, in addition, that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.*

IRS Revenue Ruling 59-60, 1959 1 C.B. 237.

This ruling provides guidance on the valuation of interests in closely-held entities, such as:

- The nature of the business and the history of the enterprise from its inception.
- The economic outlook in general and the condition of the business.
- The book value of the stock and the financial conditional of business.
- The earning capacity of the company.
- The dividend-paying capacity.
- Whether or not the enterprise has goodwill or other intangible value.
- Sales of the stock and the size of the block of stock to be valued.
- The market price of stocks and corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

RSM

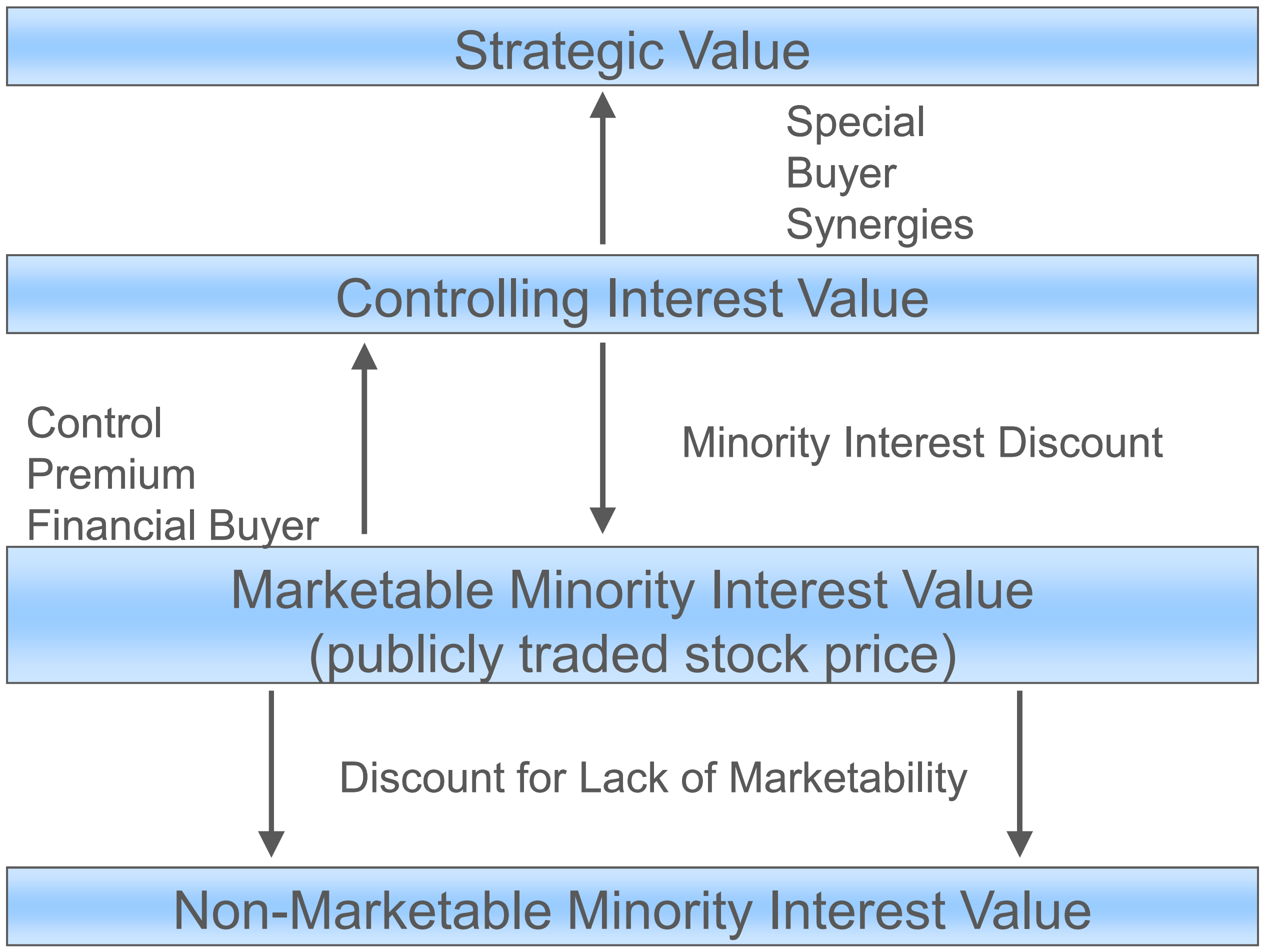
Valuation Process Agreements

- Level of value
  - Per share
  - Per ownership interest
  - Discounts for lack of control
  - Discounts for lack of marketability
  - Applicable discounts greatly impact the value determined

Establish the Correct Level of Value

- **Control, marketable**. This represents the value of a company to a controlling owner. The value of a company is highest at the control, marketable level of value.
- **Minority, marketable**. This represents the value of company to a non-controlling (minority) stockholder when a public market exists for the common stock. This value is less than the control, marketable value of the company.
- **Minority, non-marketable**. This represents the value of a company to a non-controlling (minority) stockholder when no market exists for the common stock. This value is less than the minority, marketable value of the company.

Establish the Correct Level of Value



Valuation Process Agreements

- Valuation date
  - Should be defined
  - Fiscal year end
  - Calendar year end
  - Date of triggering event
- Appraiser qualifications
  - Qualified and independent
  - Accredited Senior Appraiser (ASA)
  - Accredited in Business Valuation (ABV)
  - Certified Valuation Analyst (CVA)
  - Certified Public Accountant (CPA)
  - Chartered Financial Analyst (CFA)

Valuation Process Agreements

- Standards
  - Uniform Standards of Professional Appraisal Practice (USPAP)
  - ASA Business Valuation Standards of the American Society of Appraisers
  - AICPA Statement on Standards for Valuation Services No. 1 (SSVS-1)
  - NACVA Professional Standards
  - Others

Valuation Process Agreements

- Actual buy-out
  - Life insurance
  - Notes and terms
  - Payout over term of years
  - Lump sum
  - Tax issues regarding proceeds
  - Numerous considerations

Valuation Process Agreements

- Multiple appraisers
  - Defined process
  - Parties generally know what will occur
  - Common
  - Protected by “their” appraiser
  - Lengthy
  - Expensive
  - May not be able to make timing requirements
  - Exposure to litigation
  - Subject to different interpretations
  - Can result in wide value swings if unclear agreement
  - Parties believe bias in analysis
  - Third appraiser mutually agreed to by first two appraisers
    - Can reconcile the values
    - Can determine values
    - Can select the “better appraisal”
    - Can act as mediator

Valuation ProcessAgreements

- Single Appraiser
- Name appraiser at the time of the buy-sell agreement
- Value right after buy-sell or can agree to appraisal at a later date
- Suggest valuing contemporaneously with buy-sell agreement
  - Parties can see where it stands
  - Periodic updates (annually, every two years)
  - Less uncertainty
  - Define process and structure
  - Appraiser viewed as independent by parties

RSM

Valuation ProcessAgreements

- Suggest valuing contemporaneously with buy-sell agreement (cont.)
  - Allows time to understand valuation methodologies
  - Become price until next appraisal
  - Know what will happen at trigger event
  - Lack of clarity in buy-sell agreement terms will come to light
  - Consistent basis to provide appraisal
  - Less time consuming
  - More efficient than multiple appraisers, litigation, general uncertainty
  - Facilitates company and shareholder planning

RSM

Final Thoughts

- Opposing interests with a buy-sell agreement
- Typically a selling shareholder wants a higher price and a buying shareholder wants a lower price
- Unclear and ambiguous buy-sell agreements can lead to problematic outcomes
- Many different considerations to take into account
- Revisit any buy-sell agreements/provisions with clients to see if there is an accurate understanding of the mechanics
- If buy-sell relies on book value or formula it may not be reflective of actual fair market value

QUESTIONS AND ANSWERS?

RSM US LLP

400 Locust Street, Ste. 640
Des Moines, IA 50309
515.281.9394
www.rsmus.com

RSM