What's It Worth?
Business Valuations, Mergers, Acquisitions, and Consulting
NEWSLETTER ARTICLE ARCHIVE

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Efforts to lock in value for buy-sell purposes often fail

The transaction price in a buy-sell agreement between the terminating and continuing shareholders needs to be clear, though no single approach addresses all situations. Despite the best of intentions, we've found that difficulties often arise. Whichever approach you use, our firm is available to review the likely issues—and resultant values—to "lock in" an understanding that minimizes the potential for subsequent conflict.

One of the best analyses of this contentious issue recently appeared in *Business Valuation Review*. In "Valuation Aspects of Shareholders' Buy-Sell Agreements," Richard Wise argues that "book value" may be inappropriate and unfair in determining a price. For example, a "book value," payment to the withdrawing shareholder may be substantially below a fair and reasonable amount because increases in the values of fixed and certain other assets and the existence of valuable intangibles generally will not be recognized in the calculation of book value. Using "adjusted book value" may be a potential way to avoid inequities.

If "fair market value" is the term used in the clause, then other issues should be considered, such as whether minority and/or marketability discounts apply. Other concerns that might arise without further instructions might be, "In the absence of specific instructions, does the valuator take into account the loss to the company of the terminating shareholder's future services?" and "How is corporate-owned life insurance to be treated when the company is the beneficiary?"
The date of calculation is another integral aspect of the valuation. Also, the question of whether the interim statement is to be audited (as well as who bears the cost) may need to be addressed.

There are various advantages and disadvantages of price-fixing mechanisms. When a fixed price is determined periodically, a current fair market value is maintained if the periodic setting of the price/value is adhered to, but if the parties do not routinely meet to establish an up-to-date price, the fixed price may no longer be relevant. This method also requires a fair amount of cost due to professional fees which are incurred on an annual or other periodic basis. If an independent third party determines the price/value as of the time that the specified event occurs, a current value will be provided. Using a formula approach is easy and is the least costly of any of the alternatives (as no outside professionals are retained), but is unrealistic and doesn't take into account many changes in the firm over time. Determining the price by an option's put-call arrangement may set a fair price, but it assumes that both parties have equal financial strength, and information about the company, and that the respective shareholdings are of similar size.

This article originally appeared in the Business Valuation Update™ (BVU) newsletter. For information, please visit: www.BVResources.com