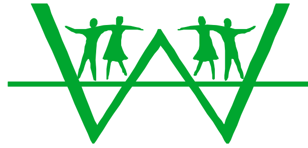

Weatherby & Associates, PC
Counselors at Law
Helping Families Preserve and Protect Assets and Values

Henry C Weatherby*+
Jeffrey S. Rivard***

*Also Admitted in MA, NJ, and ID
*** Also Admitted in NY

Joseph D. Farrell, of Counsel**

+Member National Academy of Elder Law Attorneys
**Also Admitted in CA

June 16, 2008

THOUGHT YOU'D LIKE TO SEE THIS

REVIEWING BUY-SELL AGREEMENTS
THINGS TO CONSIDER

VALUATION. The purpose of a buy-sell agreement is to establish an effective and efficient process for transfer of a business. The valuation of your client's business interest is perhaps the most critical issue covered.

There are several methods of setting the price for a buy-out of an owner's interest. Many authorities agree the most flexible way is to create a formula to set a buyout price.

Examples of formulas that might be used to value an entire business include:

- Balance sheet assets minus liabilities plus one-half of accumulated depreciation
- One and one-half times the business's gross sales for the preceding twelve months
- Seven times the average net profit of the business for the preceding three 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? None of them for any particular business since they are really just rules of thumb (ROT). The principal advantage of ROT is that they can be stated in the document but, do not necessarily reflect the true value of the company since by their limited nature ROT do not consider the intrinsic or extrinsic issues that can increase of decrease the value of the company. The best approach is to arrive at a true value of the company is to provide for an independent valuation to be done periodically to set the value. If the valuation is not done on a regular basis then the agreement should call for it at the time of a buy out for any reason with specific instructions on how the valuation is to be performed.

The key, whether a formula is used or an independent valuation is called for, is for the owners of a business to agree to the method that they believe will fairly reflect the value of the company now and in the future. Setting the method for determining the buyout price in advance maximizes the chances for a smooth transition later.

Special Valuation Issues with Family Businesses. Family dynamics, estate tax issues and competing points of view all contribute to the buy-sell quagmire.

The tax code imposes special requirements on a family business if the buy-sell agreement is intended to help fix the value of the business for state and federal death tax purposes. At the least, in a family-owned business,

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

Why is a reasonable value important? 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 are the minimum steps should a family business take to avoid these valuation issues?

1. Implement an agreement with a formula driven price.
2. Substantiate the formula by using a qualified independent professional who is familiar with valuation practices of similar businesses.
3. Review and update your agreement on a regular basis, to make sure the buyout price or formula does not become outdated or inappropriate.

As always, please feel free to call to chat about these or other planning issues of importance to you or your clients.

Sincerely,
Weatherby & Associates, PC

Henry C Weatherby