PERSPECTIVES

Common Problems in Buy/Sell Agreements

Our perspectives feature the viewpoints of our subject matter experts on current topics and emerging trends.

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INTRODUCTION

Litigation support professionals are often asked to prepare valuations or various calculations based on the language in Buy/Sell agreements, operating agreements, and purchase agreements. These agreements often do not provide clear language as to how valuations or other calculations are to be performed. This article will cover some of the common problems encountered in Buy/Sell agreements.

IMPROPER OR VAGUE ACCOUNTING TERMS

Frequently, undefined terms such as "profits," "income," or "net income" are used to describe inputs into various formulas in an agreement. However, these terms can be vague and can easily lead to undesired outcomes if not carefully defined.

In order to properly define these terms, the drafter of the agreement should, at a minimum, address the following issues:

- Are "profits" to be calculated on a cash or accrual basis?
- Should "profits" include a deduction for owner's compensation?
- What should be done if owner's compensation is under/over market?
- Should a market rate for owner's salary then be determined? If so, how should that be accomplished?
- Should income taxes be deducted?
- Should interest on owner loans to the company be deducted?
- Should earnings from investments be included?

Accounting terms need to be properly defined; otherwise, an accountant or business valuator who is asked to prepare calculations consistent with the agreement will not have sufficient direction, and unintended outcomes may result.

IMPROPER USE OF THE TERM "GAAP"

Frequently, the term "GAAP" (Generally Accepted Accounting Principles) financials is used in Buy/Sell and similar agreements. Often the term GAAP is used as shorthand for accurate financial statements (e.g., "financials should be prepared in accordance with GAAP"). However, GAAP has a specific meaning that may not be applicable to many companies.

One of the biggest problems with requiring GAAP financials in an agreement is that many companies have likely never prepared GAAP financial statements. Small and medium sized businesses typically use cash basis accounting, which does not comply with GAAP. Even if the company uses accrual basis accounting rather than cash basis accounting, the company may still not prepare GAAP financials. For example, many companies do not prepare accurate year-end accruals in accordance with GAAP. Additionally, technically, financial statements prepared under GAAP are required to have footnotes (i.e., narrative descriptions and details pertaining to the various components of a financial statement), and few small and medium size businesses prepare footnotes to their financial statements.

Therefore, when an agreement demands that financial statements are to be prepared in accordance with GAAP, and the company has never prepared GAAP financial statements, it can create a significant problem. Many companies would not be able to switch to GAAP financial statements in a timely and economic manner. Even if it were possible for a cash basis company to prepare GAAP financial statements, the newly created GAAP financials would not be consistent with previously prepared financials. A lack of comparability to prior periods (or to projections and forecasts), may or may not impact the desired objective of the contemplated agreement. Due to the high likelihood of problems arising from the improper use of the term GAAP, it is prudent to determine how the company keeps their books (cash basis financials are the most common) and then craft the requirements of an agreement accordingly (not necessarily requiring GAAP financials).

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IMPROPER USE OF THE TERM "FAIR MARKET VALUE"

The term "Fair Market Value" (FMV) is often used in Buy/Sell agreements as the standard of value used to determine an owner's interest in a company. The use of FMV is sometimes used as a default term when Fair Value may be the more appropriate standard of value.

A FMV calculation generally requires discounts for lack of marketability and lack of control for ownership interests of less than 50% of the company. Therefore, a valuation prepared using FMV will most likely result in a value, for a minority owner, significantly less than a valuation prepared using Fair Value. A Fair Value standard generally does not apply discounts for lack of marketability or lack of control.

An alternative to specifying the application of Fair Value could be to require a value determined using FMV but specifying that no discounts are to be applied.

Other factors, such as owner's compensation, often need to be taken into consideration in valuing an owner's interest in a company. Owners of small and medium size businesses rarely pay themselves the going market rate, which will then impact, positively or negatively, the profitability of the business. Therefore, the treatment of owner's compensation should be addressed in the agreement, unless a third-party business valuation is called for. Business valuators typically adjust for non-market owner's compensation when valuing a business.

Given the possibility of ending up with an unanticipated outcome, it is a good idea to consult with a valuation expert when crafting the methodology for valuing a business or an owner's interest in a Buy/Sell or similar agreement.

CONCLUSION

Buy/Sell Agreements utilize accounting and valuation terms that should be carefully considered to achieve the objective of any Buy/Sell or similar agreement. Therefore, it would be wise to have an accountant or business valuation professional, familiar with business valuations, look at your agreements to see if there are any issues or imprecise terms that require further clarity and definition to ensure the desired outcome.

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