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# Business Appraisal Practice

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# Editor's Column – A Newsletter or Discussion Idea

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Recently, while reviewing various documents for an appraisal of a mid-size company as part of an ESOP valuation, I noticed a problem.

First, some background. Two individuals founded the company over thirty years ago. At the time they incorporated their business, their attorney also drew up a shareholder purchase agreement specifying the buyout price for each other's stock at a fixed dollar amount per share. Over time, as the business grew, the two fifty percent owners increased the amount of life insurance in place on the lives of each other. Currently, the amount of life insurance in place on each of them is $5 million. The two owners believe that the company is worth $10 million – in fact, after completing the appraisal, they were not too far off.

The Problem: The owners have only updated the shareholder agreement once – in 1984. In that agreement, they agreed on a fixed dollar price per share of $1,500. Each of the two stockholders own 1,000 shares – meaning that they valued their company in 1984 at $3 million. The 1984 agreement appears to be quite thorough – it spells out all of the events that will trigger a buy out and is signed and notarized—signed by each shareholder and each spouse. No amendment to this agreement modifying the price had been made prior to the appraisal. Thus, the owners had agreed that their company was worth $3 million when in fact it was worth about three times that amount and insurance for $10 million was in place. The problem has now been solved by an update to the agreement. However, one can only imagine what would have happened had one of the two owners died prior to the update.

Periodically, when I send out newsletters or meet with an attorney, one of the points of discussion is how the attorney specifies the "price" in shareholder agreements, buy-sell agreements, etc. While business appraisers must always be careful to avoid practicing law, I believe that many attorneys could benefit from a discussion of the various ways to define the "price" to be paid in these various agreements.

I never recommend a "fixed dollar amount" as the "price" in a shareholder or buy-sell agreement. Unless the agreement is updated regularly, the fixed price can cause some serious problems for the clients and possibly for the attorney. Instead, I tell attorneys that I recommend that they require a business appraisal as the value of most businesses cannot reasonably be determined without one. I cheerfully acknowledge that this arrangement will likely result in future work for my firm but also point out that it is less likely that his or her clients will be upset with them.

Another problem that surfaces occasionally is that an attorney specifies fair market value as the standard of value to be used in a shareholder or buy-sell agreement when what is really meant is something different. A simple example would be when three equal owners form a company each investing one-third of the initial capitalization. In the buy-out agreement, if fair market value is the standard of value to be used, an owner is not going to receive a one-third

prorata amount of the total value as discounts for lack of control and lack of marketability will likely apply. I have had a number of attorneys express appreciation at having this "potential problem" pointed out. Others, of course, have known this but none have ever been upset with me for bringing up the topic.

Developing relationships with attorneys and other "gate keepers" is an important part of our business. I invite those of you that have ideas that you would like to share with others in our profession to submit them to *Business Appraisal Practice* either as a stand alone article or to be combined with other ideas in future issues.

Please submit articles or ideas for newsletters and discussions by email to: prh@hydebpv.com.

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