Buy and sell agreements term paper

Business, Company

A buy/sell agreement is good because it ensures that the business interests are transferred in an orderly and acceptable manner. The agreements reduce the misunderstandings between the potential and existing shareholders. It eliminates any conflict between the shareholders and any heirs in the business. Furthermore the company prevents unwanted persons from becoming shareholders. With the agreements, the company is able to monitor and control the people who can become shareholders (Mercer, 20100. The agreement should be in writing. Oral agreements are not enforceable in a court of law in some countries or states. The agreement serves to protect the shareholders. Finally the document helps in succession planning of the company (Fuhrman, 2007). The buy and sell agreements assists in maintaining the stability of the company operations. When an owner of the company decides to leave, through these agreements, the company gets a buyer for the shares and provision of liquidity. These buy or sell agreements help the company have less financial burdens in the area of estate taxes.

There are different kinds of buy-sell agreements. Several factors affect the kind of agreements that the company chooses to draft. These are the tax considerations, the bargaining strengths of both parties and the financial strengths of the various stakeholders.

Redemption agreements:

This is an agreement between the business owners and the company whereby the shareholder makes a commitment to sell his shares according to the terms in the agreement (Edens, 1998). The company usually purchases life insurance policies to enable it to repurchase the shares of the

business at any one given time. The company has to regularly check the insurance so that there is an assurance there is adequate coverage. Once the owner sells the shares the remaining shareholders own all the shares of the company. There is the legality aspect where a company has to check if it is allowed by law to redeem all the shares. This is because in certain states, the company cannot redeem shares that are in excess of its surplus.

Advantages and Disadvantages

One of the advantages of redemptive agreements is that the company takes few insurance policies. Secondly the creditors of the individual shareholders cannot access the insurance policies. Furthermore, the premium expense is paid by the company enabling the shareholders to evenly share the burden. The disadvantage of the method is that there are a lot of legal and tax issues involved. Secondly, the insurance proceeds that the company receives may be legible for taxation. Thirdly, with this method, the remaining shareholders do not get extra shareholding or increase in wealth value at all.

The cross-purchase agreements:

This is where the individual shareholders have made an agreement among themselves to buy shares of the departing shareholder. The shareholders get funding from insurance policies.

Advantages and Disadvantages

In the cross-purchase agreements, there is no problem of the alternative minimum tax. Additionally, the shareholders benefit as their shareholding value increases. The buy sell agreement is more flexible and easier to set up than the redemptive agreement. Furthermore, the insurance policies are

shielded from the company creditors. The disadvantage of this method is that it requires a high number of insurance policies. A lot of documentation is needed when the number of shareholders leaving the company is high. Additionally, the premiums paid will be different dependent on the ages of the owners. Lastly the shareholders pay for the premiums using earnings that have already been taxed.

Hybrid agreements:

It is a combination of the redemptive and cross purchase agreements. In this agreement, if the existing shareholders do not have the funds to buy the shares of the departing shareholder, the corporate entity has the opportunity to buy the shares.

Advantages

The method is flexible as it offers two alternate sources of funds for the purchase of the shares. This method is used to counter the disadvantages of redemptive and cross-purchase agreement. The company chooses the method that is appropriate in the particular situation. It is considered the best. They are no disadvantages as it offers flexibility and choice.

There are other kinds of buy sell agreements where the key personnel are accorded the opportunity to buy the shares of a business in a family business or a closely knit, privately owned business. On valuation of the sale agreements, there are other methods apart from insurance policies that the company can use to buy the shares. The company can use its current cash flow, cash reserve or borrowings from financial institutions. The agreements are very flexible. The leaving shareholder may leave with only a portion of

the money and receive certain amounts regularly if the installment method is used. Whichever method the company uses, it should be a flexible one. Additionally, the agreements are not static, they can be changed. The agreement is usually changed when there are dispute.

Valuation Methods

The valuation in the agreement is technical that requires expertise. There are several methods used in the valuation of buy/sell agreements.

Agreed value method:

This is where the shareholders and the company's finance officials agree on a set price per share (Gianfranco, 2009). The price is set when they are drafting the buy/sell agreement. Every year after the first year the price per share is reviewed and a new share price may be set. The companies that prefer the method argue that the shareholders and the accountants are the best people to determine the value of the company. The disadvantage with the method is that the shareholders have a tendency not to update the certificate value of the shares. The company to counter this problem should put in policies and procedures for the valuation of the shares when a triggering event occurs necessitating the implementation of the buy/sell agreement. The policies should also include several methods that can be used to adjust the share price. The price per share should be adjusted whenever the book value of the corporation increases or reduces.

Appraisal method:

In this approach the value of the shares is determined by an independent accountant with a wealth of experience in business valuations. The

agreement specifies the accountant to do the appraisal, the method to be used in the valuation and any adjustments to be made on the earnings or assets. Both the shareholders and the company accountants have to mutually agree on the appraiser. They may be conflict where both parties disagree on the choice of the appraiser. In such circumstances, both parties should nominate their appraiser who will both do the valuation. If the two appraisals submitted have a difference between 5-10%, then the average of the two appraisal values will be used. However where the appraisal values have a higher margin, the two appraisers will have to choose a third appraiser. The third appraiser will then choose between the two submitted appraisals which appraisal should be used. The third appraiser has the option of doing his own independent appraisal. The three appraisals are then averaged. Another option may be to use the mid-value appraisal among the three appraisals. The company may also simply choose to use the third appraisal results.

Valuation formulae method:

This is where formulae specified in the buy/sell agreement are used. There are many kinds of formulae used in valuation. The attorney though can only use the formulae after agreeing with the shareholders and the company accountants. Under the valuation formulae method, the book value may be used. In this approach, the appraiser simply takes the asset and liability values in the company's financial statements. The book value is the company's net worth. This is the difference between the assets and the liabilities. It is a simple method to use however there are several drawbacks in using the method. First of all the formulae does not consider those assets

and liabilities that are not disclosed in the financial statements. The current market values of the assets are not also considered. This approach leads to under valuation and over valuation of the share price. In terms of the fixed assets the book value is the cost price less the depreciation accrued. To counter the challenges in using the book value, appraisers have now resorted to using the adjusted book value method.

In this approach, other assets and liabilities not disclosed in the financial statements are included in the valuation. The fair market values of the assets are considered in the valuation. The machinery, fixed assets and inventory are valued using the fair market value. The assets that are not disclosed in the financial statements which are considered in this approach are goodwill, work in progress, expertise, patents, trademarks, copyrights, the trade or brand name and

insurance proceeds. Other items considered are contingent liabilities such as possible cases of litigation and the loss of a shareholder’s services because he is leaving or retiring. The accounts receivable are also adjusted after a thorough aging analysis for prudence concept to be adhered to. The agreement specifies all the items that should be adjusted so that both parties are aware of the adjustment processes.

The third method of the valuation formulae approach is where the appraiser capitalizes the average earnings over a period of several years. It is also known as the multiple earnings method. The agreement has to specify what the earnings are. This is because earnings can be the profits or the net profits. It can also be taken to mean the earnings after or before tax. To minimize confusion or disagreements the definition of earnings should be

given. There are certain adjustments that can be carried out on the earnings. In a company where the shareholders receive high salaries and benefits, they may be added back. The assets may have to be valued using the fair market value and the earnings consequently adjusted.

The earnings of the company are divided by the outstanding shares to give the earnings per share. The EPS rate is then multiplied with the capitalization rate. The capitalization rate is the fair rate of return. The fair rate of return is the rate of return which the shareholders are given for their investment in the company. There are other factors to be considered in the valuation of the company. The value of the shares should be the fair market value. This means that the appraiser takes into consideration the lack of marketability of the shares and the minority discounts. The buy and sell agreement should specify the date of the valuation. Is it the date of the triggering event? Should the valuation be done at the end of the accounting period? Calculating the value of the firm at the end of the accounting period is better since there are no extra costs incurred. The financial statements are usually prepared during this time. However valuation at the triggering event means extra costs are incurred in preparing the financial statements at that specific time. There have been cases where one party specifically wants the date to be at the end of the year since there will be an increase in the value of the corporation shares as opposed to using the date of the triggering event.

The date of the valuation is highly flexible. The agreement can specify different valuation dates for different triggering events. An example could be in the event of death or disability, the date of the triggering event is used. Otherwise on the event of other triggering events the date of the last

accounting period is used. The agreement can be also flexible in the methods of valuation. The parties can decide that for different triggering dates the method used in valuation is different. In the event of death or disability the adjusted book value method can be utilized. The unadjusted book value method can be used for the triggering event of termination of employment where the shareholder was also an employee of the company. All the conditions need to be clearly spelt out in the buy-sale agreement.

Conclusion

There are certain considerations to be put in mind while drafting the buy sell agreements. These considerations are important since the implementation of the agreements leads to the use of finances, may require conflict resolution and further valuation calculations. The agreements should spell out the course of action to be followed when the shareholder is bankrupt, dies or retires. At times divorce is considered if the divorce agreements advise that the shares will automatically move to the spouse (William, 2006). It is important that both parties get the best expertise on drafting of the buy/sell agreement. This is to avoid both parties realizing later that there were significant valuations or definition of terms mistakes that were put in the documents. The document should not have terms that prove to be ambiguous or have several meanings. The definition of terms should be clear and agreed upon by all the parties to the buy sale agreement. Other factors to keep in mind are that the leaving shareholders want to maximize the value of the shares while the shareholders redeeming the shares on the other hand want to minimize the value of the shares. An instance where an employee is terminated, the remaining shareholders will want to minimize

the share value. There are also tax considerations. The parties in a buy/sell agreement usually want the value of the agreement to be applicable for estate taxes. There are certain provisions to be met that are stipulated by the taxation authorities. If the provisions are not met, then the value will not be considered in determining the fair market value for federal estate taxes. In light of all the mentioned factors, the buy sell agreement is an important document for any business to aid in the continuity of the company in the event of a triggering incident like the death, retirement and dismissal of employees.

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