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WEALTH ADVISORS

Buy-Sell Agreements for Dentists

Preventing Disputes Over Value

It is not uncommon to have partners or co-owners of your dental practice. With this scenario, it is important to have a plan in place in case one partner becomes incapacitated, divorced, dies, or simply wants to sell their portion of the business. A buy-sell agreement can address virtually all of these concerns, and not having one can be very costly.

A buy-sell agreement is a legally binding document that can help preserve the continuity of a business following an event that "triggers" the transfer or sale of a shareholder's ownership interest, such as death, disability, retirement, divorce, or bankruptcy. Moreover, buy-sell agreements can help protect the financial interests of shareholders and their families.

When transitions of ownership occur within a company, disputes can arise if there is no agreement in place to facilitate a transaction involving an owner's shares. One key to avoiding such disputes is to be sure that your buy-sell agreement includes a valuation mechanism for determining a fair price for an owner's shares.

Valuation Mechanisms

The three valuation mechanisms most commonly found in buy-sell agreements include fixed-price, formula and business valuation process agreements. Below we explain each mechanism and discuss which is more effective in preventing disputes and protecting the interests of shareholders.

Fixed-Price

In a fixed price agreement, the owners of a company set a specific dollar amount per share to be paid for an owner's interest following a triggering event. Many of these agreements state that the purchase price should be updated periodically. In reality, however, these agreements are seldom updated and many are left unchanged for years. Furthermore, the original price set by the owners may not have been at fair market value.

As a company evolves, its value will deviate from the one set in a fixed price agreement unless it is updated regularly. As a result, the party purchasing the other's shares may end up paying too much or too little. The resulting inequity can lead to conflicts or time-consuming litigation that can distract the owners and disrupt the business.

Formula Pricing

Predetermined business valuation formulas are often used in buy-sell agreements to calculate the value of an ownership interest following a trigger event. However, formula agreements are often flawed because they don't reflect ongoing changes within the company, industry, or economy. Therefore formulas must be updated periodically to reflect prevailing conditions.

For example, suppose a buy-sell agreement states that the price of an ownership interest should be determined using a formula based on book value. The issues associated with using book value, which is the difference between a company's assets and liabilities, are that the company's balance sheet won't reflect the value of goodwill or intangible assets and that its assets will be listed at book value rather than fair market value.

Some buy-sell agreements use adjusted book value, which is calculated by adjusting specific assets to reflect fair market value and by including the fair market value of goodwill and intangible assets. If an agreement uses adjusted book value, it must specify any items to be adjusted or included in the calculation. Therefore, frequent updates may be required to reflect changes in the company.

Multiple-of-earnings formulas are also commonly used in buy-sell agreements to determine value. The agreement may state that the formula should use a particular earnings base and a valuation multiple agreed upon by the owners. A valuation multiple represents the rate of return that an investor would expect by assuming ownership of a company given a specific level of risk. As the company, industry, and economy change, the valuation multiple set in a buy-sell agreement may no longer reflect the current risks and expected rate of return associated with the business. The formula may also not account for all necessary and appropriate earnings adjustments.

Business Valuation Process

Many buy-sell agreements outline a process for selecting a third-party valuation professional to appraise the company following a trigger event. A third-party appraisal will reflect prevailing market conditions and help ensure that a shareholder receives a fair and reasonable price for his or her interest.

An agreement may specify which person or entity will perform the appraisal or set guidelines for resolving disagreements if parties can't agree on a single appraiser. In some cases, a buy-sell agreement can establish how to reconcile the difference between two values if multiple appraisers are used. If an agreement calls for a third-party appraisal, it should also specify business valuation components, such as standard and premise of value, the valuation date, and the use of valuation discounts. Defining these components can help minimize the likelihood of disagreements over share value.

Business owners can further minimize the risk of conflicts by obtaining a business valuation when initially drafting a buy-sell agreement. In doing so, parties can observe the valuation process, which establishes a baseline for how the company will be valued following a triggering event. Any disagreements over the valuation process or initial value can be addressed before the agreement is finalized, which can help minimize disputes in the future. Furthermore, by obtaining a valuation when drafting a buy-sell agreement, it will be less time consuming and less expensive to obtain periodic updates.

Reviewing Your Current Agreement

If you have a buy-sell agreement in place, you and your partners should periodically review it to ensure it meets your objectives and reflects ongoing changes within your company. If you are concerned with certain aspects of your agreement, such as an outdated formula or fixed-price mechanism, consult with your advisors on how to fix them. With the help of a valuation professional, you and your attorney can implement a valuation mechanism that will help avoid unexpected issues and provide peace of mind to you and your fellow shareholders.

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