Valuation & Litigation Briefing

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6 common valuation pitfalls in shareholders' agreements

The purpose of a buy-sell agreement is to ensure a smooth transfer of ownership and avoid disputes over the buyout price when an owner dies or otherwise leaves the business. But a poorly written buy-sell can have the opposite effect: Ambiguity, missing terms or poorly conceived valuation mechanisms increase the likelihood of disputes when a triggering event occurs. Here are six potential pitfalls to avoid.

1. Using a fixed price or formula

Some buy-sells set a fixed buyout price or call for the price to be calculated using a valuation formula, such as book value or a multiple of earnings before interest, taxes, depreciation and amortization (EBITDA). This approach offers simplicity and low cost.

Although these metrics may provide a reasonable measure of value when executing the agreement, they're unlikely to reflect changes in the company's value over time. This shortcoming can lead to unreasonable results and disputes down the road.

2. Providing for a negotiated price

Other buy-sell agreements require the parties to negotiate the buyout price when an owner dies or another triggering event occurs. But the parties have conflicting interests: The buyer wants to pay the *lowest* possible price, and the seller wants to receive the *highest* possible price.

Bridging the gap between the buyer (the company or its remaining owners) and the seller (the departing owner or his or her heirs) can be challenging. Disputes often arise, defeating the original purpose of the agreement.

3. Failing to establish qualifications for experts

The most reliable way to value a private business interest is to obtain an independent appraisal from one or more qualified experts at or near the buyout date. This helps ensure that the price accurately reflects the qualities that distinguish the company from others in its industry.

It's critical for experts to possess credentials from a reputable business valuation organization and to be independent of the company and its owners. Also consider establishing minimum levels of education and valuation experience.

4. Neglecting to specify the standard and level of value

Always define the term "value" in a buy-sell agreement. Typically, fair market value is the appropriate standard of value. But if left undefined, the meaning may be uncertain and lead to disputes.

Similarly, the buy-sell should specify whether to value a minority interest in the company (which may

Imprecise buy-sell leads to unpleasant surprises

A recent Ohio appellate court case, *Kashmiry v. Ellis*, illustrates the dangers of relying on a buy-sell agreement that's not carefully drafted or followed. In this case, the agreement provided two mechanisms for valuing the company's stock: 1) annual valuations of the company's shares unanimously agreed upon by the shareholders, and 2) valuation by a qualified appraiser after a triggering event.

The shareholders failed to obtain annual valuations. So, after a minority shareholder was terminated (a triggering event), the company invoked the second valuation mechanism. The appraiser valued the shares at a fraction of the price for which the shareholder had acquired his shares five years earlier (around $7,500 per share, based on a multiple of the company's gross revenues), in part because she applied substantial minority interest and marketability discounts.

The trial court valued the stock at $7,500 per share, criticizing the appraiser for ignoring the original purchase price of the stock. The appellate court reversed and remanded, finding it inappropriate to give *controlling weight* to a single, five-year-old valuation.

We have no updates on whether the trial court revisited its valuation or the parties settled their differences. But litigation might have been avoided if the shareholders had followed their buy-sell agreement by obtaining annual valuations of the stock. In addition, the issue of valuation discounts might have been settled outside of court if the parties had more clearly defined the term "value."

be discounted for lack of control and marketability) or the owner's proportionate share of the company's entire value.

5. Overlooking the valuation date

A company's value can change dramatically over time. For example, a company's value may soar after a merger or new patent is announced. Or its value might plummet after loss of a key executive or major customer. Unless a buy-sell agreement provides a mechanism for selecting the valuation date — such as the last day of the company's most recent fiscal year or quarter — disagreements are likely.

Though it's tempting to use the date of the triggering event as the valuation date, this approach is susceptible to manipulation by owners who time their departures to maximize the buyout price. Plus, it's easier to use a valuation date that coincides with the end of an accounting period.

6. Setting unreasonable time limits

The valuation process can't be rushed. The expert must gather and analyze financial data, conduct management interviews and site visits, and write the valuation report.

Disputes may arise if time limits for agreeing on a negotiated price are unrealistically short. In addition, it may take time for the parties to find qualified business valuation experts — and an expert might have other engagements to finish before starting your case.

Involve a valuation pro upfront

Don't wait for a triggering event to consult a business valuation professional. During the drafting of a buy-sell agreement, he or she can help ensure that the valuation provisions are fair, complete and unambiguous. It's also critical to review buy-sell agreements on a regular basis and amend them as needed. ■

How financial experts can help in divorce

Divorce involves complex financial issues. Fortunately, a financial professional can help the parties resolve such matters as divvying up a marital estate and valuing private business interests. It's also important for the parties to understand the tax implications of various settlement options under current tax law.

Dividing up the marital estate

The first step is to compile a marital balance sheet. The couple may own such assets as:

- Savings and checking accounts,
- Vehicles and equipment,
- Principal residences, vacation homes and other real property,
- 401(k) accounts, IRAs, pensions and other retirement savings,
- Marketable securities,
- Private business interests, and
- Jewelry, artwork, furniture and other personal assets.

Examples of marital liabilities include credit card debt, student loans, vehicle loans, home mortgages and lines of credit, and retirement account loans. Whether the couple's individual assets and liabilities are includable in the marital estate is generally a matter of law, which varies from state to state.

Once marital assets and liabilities have been cataloged, values must be assigned to each item. The value of bank accounts, retirement accounts and debts can be taken from the latest account statement. But other items, such as real estate, collectibles and private business interests, may require an independent outside appraisal — or

they may be sold to a third party, so the spouses can share the proceeds.

When the parties own an interest in a closely held business, selling usually isn't an option. Instead, a business valuation expert is used to determine its "fair value." Any value that's not attributable to net tangible assets and identifiable intangible assets is considered "goodwill." The treatment of goodwill in divorce varies from state to state. Your expert can help determine the extent to which goodwill is includable in the marital estate based on the specific facts and circumstances.

Factoring taxes into the equation

In general, assets can be transferred between spouses tax-free, but the transfers may be subject to certain rules and restrictions. It's also important to consider that assets may trigger varying tax liabilities if they're eventually sold for a gain.

For example, the Chavezes have two major assets: 1) an investment account with a current market value of $200,000, and 2) a principal residence valued at $500,000 with a $300,000 remaining mortgage (a net value of $200,000). At first glance, it might seem equitable to give one spouse the investment account and the other the house with the mortgage.

However, after factoring in taxes, the division might not be exactly 50/50. Suppose the investment account has a tax basis of $50,000. If sold, the account would generate a taxable gain of $150,000. On the other hand, a capital gain of up to $250,000 (or $500,000 for married people who file a joint tax return) from the sale of a principal residence may be excluded from taxable income, if certain conditions are met.

Need help?

Divorce can be emotionally charged, and the parties may not be familiar with the financial issues that can arise. An outside financial expert can provide objective guidance on how to value assets and distribute them equitably in light of the spouses' personal preferences, potential taxes, applicable state law, and required child support and alimony payments. ■

Estate of Jones

Valuing gifts of LP interests in income-producing real estate

The U.S. Tax Court addressed several important business valuation issues in a recent gift tax case. Here's an overview of why the court applied the income approach, not the cost approach, to value a limited partner (LP) interest in a timber business, as well as how it handled the use of management's projections and the tax-affecting of the earnings of a "pass-through" entity.

Case facts

In May 2009, Mr. Jones gifted the following business interests to individual family members and various family trusts:

- 1,300 shares of class A voting stock in Seneca Sawmill Co. (SSC),
- 10,256 shares of class B nonvoting stock in SSC, and
- 10,267.67 LP units in Seneca Jones Timber Co. (SJTC).

SSC is a lumber manufacturer that sells lumber around the United States, primarily for use in the housing industry. In 1986, the company elected to be taxed as an S corporation.

SJTC is a limited liability partnership (LLP), created in 1992 to acquire, hold and manage timberlands. SJTC's holdings were intended to be SSC's inventory. SSC served as the general partner for SJTC, making all of its management decisions. As of the valuation date, SSC's largest supplier of logs was SJTC.

The IRS didn't submit a valuation of SSC and largely accepted the valuation methods that the estate's expert used to value SSC. So, the primary issue in this case was the fair market value of an LP interest in SJTC.

The 2009 gift tax return reported that the value of each LP unit was $350. After receiving a deficiency notice from the IRS, the estate hired another business valuation expert who estimated that the value of each LP unit was $380, an increase of about 9% over the amount reported on the original gift tax return. In contrast, the IRS's expert opined that the value of each LP unit was $2,530, more than *six times* the amount set forth by the estate's expert.

Holding company vs. operating company

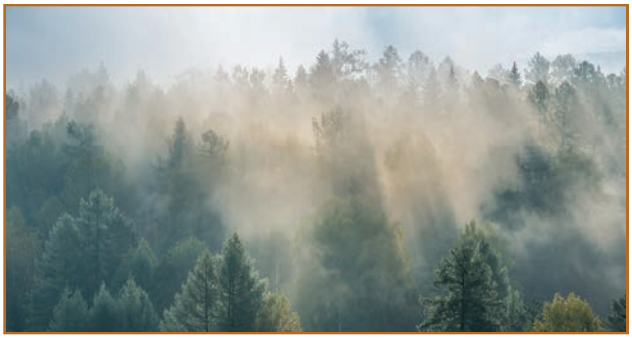
The IRS's expert contended that SJTC was a holding company that should be valued using the cost (or asset-based) approach. Conversely, the estate's expert argued that SJTC was an operating company that should be valued using the income approach.

The Tax Court determined that SJTC had aspects of both an operating company and a holding company. But, after accounting for SSC's control of SJTC and the economic interdependence between the companies, the court found it unlikely that the partnership would sell its underlying assets (the timberlands). Therefore, it decided that the discounted cash flow (DCF) methodology used by the estate's expert was the more appropriate way to value SJTC.

Management's projections and tax-affecting

The IRS criticized two aspects of the DCF analysis. First, it argued that revised projections prepared by management in April 2009 were "unreliable." But the court accepted them as inputs into the DCF model, because they were the most current projections available, and management had relied on them for business decisions at the valuation date.

Second, the IRS argued against the application of a 38% combined state and federal corporate-level rate to SJTC's earnings before interest and taxes. SJTC (an LLP) is a so-called "pass-through" entity. That means it doesn't pay taxes at the entity level; instead, earnings are passed on to the partners and taxed at their individual tax rates.



To reflect the benefit of avoiding taxes on future dividends paid out to partners, the estate's expert applied a premium in his DCF analysis. The court said his tax-affecting methodology "may not be exact, but it is more complete and more convincing than respondent's zero tax rate."

Court sides with estate's expert

Ultimately, the Tax Court accepted the values set forth by the estate's expert in their entirety, including his application of a 35% discount for lack of marketability. The estate admitted to owing a deficiency of roughly 9% from the amount originally reported on the 2009 gift tax returns. But the court rejected all the IRS's arguments on the valuation of the LP interests that were presented in court. ■

AICPA finalizes fair value guidance for investment companies

The American Institute of Certified Public Accountants (AICPA) recently finalized guidance for investment companies on determining the fair value of their portfolio company investments. The guide, *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies*, is more than 600 pages and includes extensive examples and case studies.

Estimating the fair value of private equity and venture capital investments is challenging, because professional judgment plays a prominent role in the process. As a result, the methods used to value

these investments are diverse and often inconsistent. According to the AICPA, the guide is designed to "harmonize views of industry participants, auditors and valuation specialists." Here are some key issues the guide covers.

Market participant's perspective

Under U.S. Generally Accepted Accounting Principles (GAAP), fair value is "the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date." Factors to consider include:

- Company-specific characteristics (such as its sector, stage of development and management experience),
- Required rate of return for comparable investments,
- Expected holding periods for comparable investments, and
- Recent transactions involving the same or similar investments.

A portfolio investment should be valued from a market participant's perspective, rather than the perspective of a specific investor.

Valuation of debt

The guide addresses the valuation of debt from two distinct perspectives: 1) as an investment, and 2) in connection with valuing equity. It also explains why many traditional measures don't accurately reflect the fair value of debt.

In general, traditional measures fail to incorporate a current assessment of market conditions or the borrower's credit quality. When a traded price isn't available or isn't indicative of fair value, the guide suggests using the yield method. Under this method, expected cash flows over the life of the debt are converted to present value using an appropriate market yield (or discount rate).

Calibration

The guide devotes an entire chapter to calibration. Under this valuation technique, a firm uses certain multiples or other inputs derived from recent portfolio transactions reported at fair value.

These amounts are then applied to the same assets in subsequent periods. However, the valuator adjusts the inputs to reflect changes between the transaction date and the measurement date.

Best practices

The AICPA's guide provides thorough coverage of many valuation techniques and considerations. Although it's nonauthoritative, the guide was prepared with input from major accounting firms, industry participants and valuation specialists. So, it's intended to reflect best practices in financial reporting and business valuation. ■