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Advising Clients on Buy/Sell Agreements

presented by the GYF Business Valuation & Litigation Support Services Group

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Grossman Yanak & Ford LLP

Headquartered in Pittsburgh, Grossman Yanak & Ford LLP is a regional certified public accounting and consulting firm that provides assurance and advisory, tax planning and compliance, business valuation, ERP solutions and consulting services. Led by six partners, the firm employs approximately 55 personnel who serve corporate and not-for-profit entities.

Our firm was founded in 1990 on the idea that the key to successful, proactive business assistance is a commitment to a high level of service. The partners at Grossman Yanak & Ford LLP believe that quality service is driven by considerable involvement of seasoned professionals on a continuing basis. Today's complex and dynamic business environment requires that each client receive the services of a skilled professional with a broad range of experience and knowledge who can be called upon to provide efficient, effective assistance.

Grossman Yanak & Ford LLP combines a diversity of technical skills with extensive "hands-on" experience to address varied and complex issues for clients on a daily basis. We pride ourselves on bringing value-added resolution to these issues in a progressive and innovative manner. Our ability to produce contemporary, creative solutions is rooted in a very basic and ageless business premise – quality service drives quality results. Our focus on the business basics of quality technical service, responsiveness and reasonable pricing has enabled the firm to develop a portfolio of corporate clients, as well as sophisticated individuals and nonprofit enterprises.

Our professionals understand the importance of quality and commitment. Currently, the majority of the professional staff in our Assurance & Advisory Services and Tax Services Groups hold the Certified Public Accountant designation or have passed the examination and need to complete the time requirements for certification. Each of our peer reviews has resulted in the highest-level report possible, attesting to the very high quality of our firm's quality control function. The collective effort of our professionals has resulted in our firm earning an exemplary reputation in the business community.

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Robert J. Grossman, CPA/ABV, ASA, CVA, CBA

Bob heads our firm's Tax and Business Valuation Groups. He has over 35 years of experience in tax and valuation matters that affect businesses, both public and private, as well as the stakeholders and owners of these businesses. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth. As his career has progressed, Bob has risen to a level of national prominence in the business valuation arena.

His expertise in business valuation is well known, and Bob is a frequent speaker, regionally and nationally, on tax and valuation matters. Bob is a course developer and national instructor for both the American Institute of Certified Public Accountants (AICPA) and the National Association of Certified Valuators and Analysts (NACVA). He has served as an adjunct professor for Duquesne University and Saint Vincent College. He has also written articles for several area business publications and professional trade journals.

After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is accredited in Business Valuation by the AICPA. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

A member of the American and Pennsylvania Institutes of Certified Public Accountants (PICPA), Bob has previously chaired the PICPA Pittsburgh Committee on Taxation. He has also served as Chair of the Executive Advisory Board of NACVA, its highest Board; as well as Chair of NACVA's Professional Standards Committee and its Education Board.

Bob received NACVA's "Thomas R. Porter Lifetime Achievement Award" for 2013. The award is presented annually to one of the organization's 6,500 members, who has demonstrated exemplary character, leadership and professional achievements to NACVA and the business valuation profession, over an extended period.

Bob is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the American Society of Appraisers. He has held numerous offices in various not-for-profit organizations. Bob received the PICPA Distinguished Public Service Award and a Distinguished Alumnus Award from Saint Vincent College.

Bob and his wife, Susie, live in Westmoreland County. They have two grown children.

Melissa A. Bizyak, CPA/ABV/CFF, CVA

Melissa, a partner in the firm's Business Valuation & Litigation Support Services Group, has practiced in public accounting for more than 21 years. She has significant experience in business valuation and tax-related issues for privately held concerns and their owners.

Her business valuation experience is diverse, including valuations of companies in the manufacturing, oil and gas and technology industries. These valuations have been performed for various purposes such as financial reporting, equitable distributions, buy/sell transactions, dissenting shareholder disputes, Employee Stock Ownership Plans (ESOPs), value enhancement and gift and estate tax purposes. Melissa also provides litigation support services including expert witness testimony.

After graduating from the University of Pittsburgh in 1994 with a B.S. in Business/Accounting, Melissa spent two years with a local accounting firm in Pittsburgh. She joined Grossman Yanak & Ford LLP in 1997.

Melissa is a certified public accountant and is accredited in business valuation and certified in financial forensics by the American Institute of Certified Public Accountants (AICPA). She has also earned the AICPA Certificate of Achievement in business valuation. Additionally, Melissa carries the credentials of Certified Valuation Analyst.

Her professional affiliations include the AICPA, the Pennsylvania Institute of Certified Public Accountants (PICPA) and the Estate Planning Council of Pittsburgh. She is a member and previously served as the Chair of the Executive Advisory Board of the National Association of Certified Valuators and Analysts (NACVA). Melissa has written business valuation course-related materials and serves as a national instructor for NACVA. She has also authored articles appearing in professional publications.

Melissa is a graduate of Leadership Pittsburgh, Inc.'s Leadership Development Initiative. She serves on the Board of Directors of the Children's Museum of Pittsburgh and is a member of the Executive Leadership Team for the American Heart Association's "Go Red for Women" initiative. Melissa is also a mentor for women business owners through Chatham University's MyBoard program. She was one of four female CPAs in the State of Pennsylvania to be honored in the PICPA's "Women to Watch" awards in 2017.

Melissa resides in the South Hills of Pittsburgh with her husband and their two sons.

Brad W. Matthews, CPA, CVA

Brad has focused his career on providing valuation and litigation support services since joining Grossman Yanak & Ford LLP in 2011. His experience includes financial statement and historical financial trend analysis, financial modeling, and business risk assessment, as well as performing calculations required for the preparation of business valuations and other consulting projects.

Brad has served clients in many industries including manufacturing, professional services, financial services, engineering, construction, retail, management consulting, oil and gas, and technology. He has played a significant role in providing business valuation services for a range of purposes including gift and estate tax planning, Employee Stock Ownership Plans (ESOPs), marital dissolutions, corporate divorce/shareholder disputes, financial and tax reporting, buy/sell transactions, and general business planning. Further, his litigation support experience includes the determination of lost profits and economic damages arising from various disputes.

Brad graduated from the University of Pittsburgh, earning a double major in Accounting and Finance with a minor in Economics. Brad is a graduate of Class XXIV of Leadership Pittsburgh Inc.'s Leadership Development Initiative (LDI) program that hones the leadership skills of high-potential young professionals.

He is a certified public accountant (CPA) and has earned the Certified Valuation Analyst (CVA) designation conferred by the National Association of Certified Valuators and Analysts (NACVA).

In his spare time, Brad enjoys golfing, following Pittsburgh sports and spending time outside with his family. He lives in the North Hills with his wife, Alexis.

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Advising Clients on Buy/Sell Agreements

I. Introduction

Perhaps no corporate document is more critical to the organization of a new or existing business enterprise than a ***buy/sell agreement***.[1] Unfortunately, all too often, participants in a new business venture find themselves so enamored with visions of success and grandeur that the many implications of a possible equity owner departure far into the future is mistakenly interpreted to mean that focus on this important document is not required at inception. Nothing could be further from the truth.

Likewise, equity owners involved in a more mature operating company are always more focused on operational matters and business exigencies rather than back-room administrative tasks. Even those equity ownership groups that pay particular attention to corporate matters often fail to look at buy/sell agreements as living and evolving documents requiring an almost annual focus.

A failure to address complex potential equity owner exit issues at the inception of a business is one of the most prolific drivers of controversy among business partners. While perfect ownership harmony may never fully exist, there is likely no time in a business's existence when the equity owners are more aligned than in the start-up stage. As such, complex matters such as equity valuation and equity repurchase protocol are more easily addressed at this time than at any other as the business grows.

Often, exits from the business are accompanied by misinformation, high emotions and, regularly, litigation. The outgrowth of such an exit process is, at best, a commitment of substantial personal time, effort and aggravation on the part of the entire equity owner group. A very contentious process can also involve an incredible and unnecessary monetary spend on professionals, including attorneys, accountants and other experts. Perhaps the worst possible outcomes are permanent harm to the business itself and hurt feelings on all sides, resulting in lost friendships and relationships that can never be repaired or replaced.

Many of these negative outcomes can easily be avoided with a properly crafted buy/sell agreement. The best time to address these concerns, as noted, is at the businesses' founding and inception. However, it should be noted that users of buy/sell agreements are best served when treating such agreements as "ever-evolving" and "living" documents, allowing for regular updates to account for changes in the goals and wishes of the business and the equity owners. It is also important to regularly update the valuation of the company to ensure that all equity owners are able to discern the worth of their ownership interests throughout the life of the business.

[1] The term "buy/sell agreement" referenced throughout these materials is intended to include, unless otherwise noted, those provisions addressing circumstances relating to acquisitions and sales of equity ownership interests in shareholder agreements, partnership agreements and limited liability company operating agreements. Likewise, the term "equity owner" is intended to equally apply to corporation shareholders, partners and limited liability company members. Note that these materials are not intended to be authoritative and do not address specific income tax implications related to differences in operating entity structure.

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What happens when attention is not given to developing a proper buy/sell agreement? A great illustration, and a good lesson, can be drawn from one recent court decision and ultimate settlement, related to a company that is likely familiar to all of the readers of these materials. That company became the center of a "six-year, knock-down, drag-out battle," as described by *Fortune* in June 2014.[2]

Arizona Tea and a number of related companies (hereafter, "Arizona" or "the Arizona entities") was founded in 1992 by two long-time friends, John Ferolito and Dominick Vultaggio, from Brooklyn, New York. Before starting Arizona, the two men sold beer together out of the back of a Volkswagen bus in the 1970s. The Arizona entities market a variety of beverages, principally iced tea products, lemonade-tea blended drinks and fruit juice-based products, which can be found at many retail outlets, including grocery and convenience stores.

The business started with a delineation of duties between the two founders. Ferolito managed the financial affairs of the companies, and Vultaggio ran warehouse operations. In the mid-1990s Vultaggio moved to the front office to better learn the business side of the operation. This move opened the door to an ongoing and never-ending series of disputes. By 1997, just five years after Arizona's founding, both men realized that only one of them could captain the ship. In 1998, Ferolito ceded day-to-day control to Vultaggio, via a formal agreement, and stepped away from active involvement to pursue other business and leisure interests. This arrangement worked to keep both men happy, and at peace, until 2007. Note, no formal buy/sell agreement was executed.

In 2007, Ferolito started to explore a sale of his shares in Arizona to Tata Global Beverages, Ltd., the world's second largest tea manufacturer and distributor. The deal value was preliminarily set by Tata at $2.25 billion. However, the problem that arose was that Ferolito had given up day-to-day control to Vultaggio in 1998, and that agreement required that both founders must consent to any sale of company stock to outsiders.

An initial suit by Ferolito, asking a judge to rule the agreement unenforceable, was lost. Vultaggio ultimately decided to pursue a legal remedy himself later, electing to exercise his right under New York state law to buy out Ferolito. Instead of resolving the situation, however, the strategy proved complex due to the question of valuation and exactly how much the equity interest held by Ferolito was worth.

Arizona is a great American business story, and the company was incredibly successful under any measurement standard. By calendar year 2000, just eight years after it was founded, the men had each taken over $500 million dollars out of the business. By 2010, Arizona claimed a 33.9% share of the ready-to-drink tea market, edging out competition from PepsiCo's Lipton Tea, Coca Cola's Nestea and even Dr. Pepper Snapple Group's Snapple, according to *Beverage Digest*. Sales in 2010 neared $1 billion, and the companies' employee count rose to approximately 1,000. In 2013, Arizona's share had grown to 37.4% of the total ready-to-drink tea market.

[2] *Fortune*, http://fortune.com/2014/07/10/arizona-iced-tea/

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In the intervening period between Ferolito's initial discussions with Tata and May 2014, at the start of what became a six-week trial,[3] Ferolito's attorneys argued that there had been bids not only from Tata, but also from Nestle and Coca-Cola, which set the value of Arizona as high as $4.25 billion. The lawyers further argued that "Fair value is equal to what a willing purchaser would pay for Arizona." Vultaggio's attorneys argued that the value was less than $500 million because the offers were not binding.

Not only was Arizona an exceedingly profitable, attractive company, but more important to the concept of valuation, it was also growing faster than its competitors and the industry at the applicable dates of valuation. Its earnings before interest taxes depreciation and amortization (EBITDA) was estimated by one expert in the case at $181 million in 2010.

Legal counsel for Ferolito interpreted fair value in New York as being the strategic control level based on a case, *Friedman v. Beway Realty Corp.*[4], and cited the following language from within that decision:

> *[I]n fixing fair value, courts should determine the minority shareholder's proportionate interest in the going concern value of the corporation as a whole, that is, "what a willing purchaser, in an arm's length transaction, would offer for the corporation as an operating business."*

Ferolito's experts provided estimates of the "strategic control value" at $3.2 billion to $3.6 billion. However, the Court did not concur that strategic control value was appropriate, citing a number of cases and concluding:

> *These principles make clear that the Court may not consider Arizona's "strategic" or "synergistic" value to a third party purchase, as Ferolito urges. A valuation that incorporates such a "strategic" or "synergistic" element would not rely on actual facts that relate to Arizona, as an operating business, but rather would force the Court to speculate about the future.*[5]

The Court dismissed the preliminary offers from the outside buyers as irrelevant since they never advanced to the stage of due diligence, nor were the potential transactions voted upon by Arizona's Board of Directors. Ultimately, the Court decided to value Arizona on the level of value generally referred to as "financial control."

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[3] *John M. Ferolito and JMF Investments Holdings, Inc., Plaintiffs, against Arizona Beverages USA LLC, AZ National Distributors LLC, Arizona Beverage Company LLC, Defendants,* In the Matter of the Application of John M. Ferolito, the Holder of More Than 20 Percent of All Outstanding Shares of Beverage Marketing, USA, Inc., Petitioner, For the Dissolution of Beverage Marketing, USA, Inc., John M. Ferolito and the John Ferolito, Jr. Grantor Trust (John M. Ferolito and Carolyn Ferolito as Co-Trustees), both individually and derivatively on behalf of Beverage Marketing USA, Inc., Plaintiffs, against Domenick J. Vultaggio and David Menashi, Defendants. New York Supreme Court, Nassau County, No. 004058-12. ("Ferolito v. Vultaggio")

[4] *Friedman v. Beway Realty Corp.*, 87 N.Y.2d 161, 168 (1995) (emphasis in original) quoting *Matter of Pace Photographers, Ltd.*, 71, N.Y. 2d 737.748 (1988)

[5] *Ferolito v. Vultaggio*

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The Court utilized a discounted future returns method that included consideration of one expert's 10-year financial projection of both revenues and expenses. While the business valuation process and the Court's determination of financial control is exceedingly complex, its methodologies are well detailed in the opinion. Suffice to say that the Court found the financial control value to be approximately $2 billion. Its decision was lower than Ferolito's expert had provided for "financial control value" at $2.4 billion. The exact amount of the Court's value assessment was to be determined by a jury trial when a settlement was reached by both parties, ending more than six years of fighting. Exact details of that settlement are unavailable.

The issues set forth in the case far outreach the simple explanation noted today, but the matter is included to illustrate the frustration and effort that is required when organization documents are not sufficient to answer equity owner departure scenarios. From an inside source known to the authors, trial preparation and expert fees approximated $2 million monthly on each side as the date of trial approached. Perhaps the take away from this case is that even business partnerships forged by friends over sweet tea can go sour.[6]

The primary means to avoid conflict, such as that found in the Arizona debacle, is for organizations to have a clear, comprehensible and technically complete buy/sell agreement. Moreover, as noted earlier, the document must evolve as both the business and the equity owner group change over the life of the business.

Buy/sell agreements set out the mechanisms by which ownership transition occurs within a business's life cycle, and its importance is accentuated by the fact that most additions and departures of equity owners must be governed by a quality document to ensure smooth transition from one ownership group to another (even if certain equity owners remain indefinitely as members of multiple ownership groups.)

The primary responsibility for craftsmanship of a proper and technically complete buy/sell agreement lies generally within the expertise of those practicing in the legal community. However, the complexities that require focus in the agreements often bridge complex financial and economic matters including funding determinations under a variety of scenarios and valuations. Within these two areas, that expertise held by accountants and business valuation specialists can often be helpful in drafting a better agreement, which can lead to cleaner equity owner entrances and exits with more clarity and less controversy.

Periodic review of buy/sell agreements can provide a great opportunity to assist clients and business owners and generate practitioner's/advisor's goodwill. In one recent survey of small business owners, only 21% had a formal written plan to transfer their shares of their businesses at death. Fewer yet had any formal buy/sell agreements with partners and co-owners.

[6] *Fortune*, http://fortune.com/2014/07/10/arizona-iced-tea/

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A sound buy/sell agreement should reflect the equity owner group's consensus on a number of critical elements of consideration that should be identified, discussed and addressed in the planning process in anticipation of preparation of the document. These core elements can be delineated into five broad areas:

1. Identify the parties to the agreement and the rights granted each to party thereunder
2. Identify available structures to allow for selection of the one that presents the most desirable transition and tax outcomes
3. Identify and define all appropriate trigger events invoking the operative provisions
4. Identify and define the proper manner to set the price of the equity interests
5. Identify and define the terms of payment and the mechanisms by which the consideration will be paid

These elements of consideration should be important to all members of the equity ownership group. If properly addressed in the planning and drafting of the agreement, the process should allow for a final document that is both efficient and authoritative to guide the equity owner group through any number of complex ownership changes over the life of the business. Each of these core elements is discussed within these materials, which are divided into the following sections:

- ***Chapter II – Fundamental Considerations in Buy/Sell Agreements*** focuses on the basic elements of a buy/sell agreement, some of the uses of buy/sell agreements in traditional business settings, basic structural choices, and the benefits of having a sound agreement in place.

- ***Chapter III – Structure Considerations*** will address a number of economic and tax considerations, and is intended to introduce common buy/sell agreement arrangements and explain how each of these operates within a business to facilitate smooth equity owner transition. The section will also discuss the advantages and disadvantages of each structure.

- ***Chapter IV – Valuation*** will focus on this all-important issue, and discuss how valuation provisions (or the lack of appropriate or clear valuation provisions) often generate the greatest level of consternation and conflict. This section explains how valuation parameters such as standard of value, premise of value, and how value is to be determined, are paramount to a quality buy/sell agreement.

- ***Chapter V – Case Law Examples of Problem Areas in Buy/Sell Agreements*** includes illustrations of poorly crafted buy/sell agreements and how common misunderstandings among the ownership group often fuel controversy and litigation. While not intended to be a full library of all available cases, included are a few of the more interesting cases that the authors have observed in the past.

- ***Chapter VI – Concluding Thoughts and Practical Considerations*** simply reemphasizes a few key points.

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Note that as is the case with all of our continuing legal education programs, today's presentation is not intended to be an all-encompassing source of knowledge on the topic. Rather, the program is designed to be a working overview of many of the complexities implicit in the consideration, drafting and adoption of a buy/sell agreement. We hope that, with this information, you will be prepared to return to your offices with a better understanding of the many complex matters that require your, and our, attention in this important area.

Should you have specific questions at the end of today's session, or if you have a question or matter you would like to run by us, please feel free to contact any of the authors at your convenience. Their phone numbers and email addresses are listed below.

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II. Fundamental Considerations in Buy/Sell Agreements

The many issues associated with a poorly crafted buy/sell agreement most often result from a lack of understanding of the importance of the document and the circumstances under which the document is initially drafted. In many cases, both of these elemental causes of poorly crafted buy/sell agreements date to the creation of the business itself.

As most businesses begin, the attention of all equity owners is most-commonly focused on the start-up and operation of the enterprise and the realization of the full potential of that business. The founders are working diligently to implement their business plan and to get the operations of the company up and running. There are a myriad of items to handle, legal and otherwise. Unfortunately, it is the authors' experience that at this point in the business's life cycle, the equity owners are much more interested in operational matters rather than legal ones.

However, it is exactly at this time that the parties are most likely to be agreeable to a fair and reasonable buy/sell agreement as long as it is properly drafted and all parties have a full and complete understanding of its operative provisions. Dismissing the need for careful attention to the legal documents is an oversight that can lead to major and costly battles in the future.

Furthermore, the authors have observed that the goals and objectives of the business are often in their closest state of synchronization to those goals and objectives of the equity ownership group at the inception of the business. Over the life cycle of the business, these goals and objectives will regularly run in disparate directions, as business exigencies require adjustment and focus at the same time that life circumstances dictate that equity owners turn focus away from the business. Death, illness, incapacity, divorce, personal tragedy and simple loss of interest or a desire to pursue other endeavors are just a few circumstances that force equity owners to lose focus on the business and its objectives. Many times, the only realistic resolution in these circumstances is an equity owner's exit from the business. On these occasions, the presence of a quality buy/sell agreement is critical to facilitating a smooth transition.

Few business owners that the authors have worked with on matters related to buy/sell agreements fully understood the implications of the language in those agreements. In many cases, the business owners had not even read the documents until a problem later arose. Most never revisit the language of the buy/sell agreement after it is executed until there is an issue with equity owner trigger events and departures. Upon inquiry of these business owners, they note that no one had ever explained the possible negative impacts of buy/sell agreements that lack clarity or that include provisions that are misaligned with the businesses' or equity owners' goals and

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objectives. They note that little or no thought was given to equity owner departures from the ownership group at the time the companies were formed. It is not surprising that the eventual enforcement of the agreement and its outcome often did not match the expectations of one or more of the equity owners at that date.

Such outcomes are clearly rooted in equity owner misunderstandings of the importance of the document. These misunderstandings could have been avoided by emphasizing the need to truly focus and study the language of the agreement prior to its execution. The specific provisions within a buy/sell agreement should be read carefully, as those provisions will serve as the operational drivers in the facilitation of a stock purchase from any departing equity owner.

Complications from the failure to fully appreciate the importance of the buy/sell agreement can be further exacerbated by the circumstances under which it is necessary to refer to its provisions. At the point when an exit is desired or required, the relationships between the owners can often be frayed and strained In contrast, at the inception of the business there is generally a positive state of mind, and the business relationships among the equity owners is not only cordial, but exceedingly friendly, making it an ideal time to discuss the key provisions of a buy/sell agreement.

Responsibility for ensuring that these matters are fully addressed generally lies with the advisor team, and principally with company legal counsel, accountants and valuation specialists. The viability and success of a buy/sell agreement, perhaps more than any other legal document, can benefit greatly by the integration of accounting, tax and valuation considerations. Such integration will lead to a more "user friendly" document when the time comes for the provisions to be invoked and an equity owner is to be bought out.

Buy/Sell Agreement Fundamentals

While the uses of buy/sell agreements are generally understood, there are few sources of reference that provide a succinct and all-encompassing definition. Perhaps that is due to the nature of the agreements and the many complexities that properly crafted buy/sell agreements are intended to address. For want of a better definition, the authors provide the following as one way to view such agreements from a business point of view:

> *A buy/sell agreement is a legally-binding agreement (essentially a contract) by and between equity owners of a business enterprise (i.e., shareholders of a corporation, partners in a partnership or members of a limited liability company) and, in some instances, by and between equity owners of a business enterprise and the business enterprise, itself. Most often, these agreements restrict the right to transfer the equity ownership interest in the company and set out agreed-upon purchase and sale rights and obligations upon the occurrence of certain events.*

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In effect, buy/sell agreements generally serve to govern the mechanics of facilitating an equity interest repurchase when an owner's departure from the ownership group is pending. Buy/sell agreements generally provide for the following:

- Timing of co-owner sales of their equity ownership interests,
- Whether the co-owner departure is mandatory or optional,
- What trigger events mandate the departure of a co-owner,
- How the value of the co-owner's equity ownership interest is to be determined,
- The terms under which the value of the co-owner's equity interest will be paid, and
- The funding mechanism by which the exiting co-owner will be paid.

Within the context of the above definition, there are three general types (structures) of buy/sell agreements that are commonly utilized. Each of these carries with it its own advantages and disadvantages. While these types of buy/sell agreements are addressed in greater depth in the next chapter, they are briefly noted and illustrated here for purposes of introducing the concepts.

Cross-Purchase Agreements

In a cross-purchase agreement, owners agree to purchase their departing co-owner's interest at an agreed-upon price. Generally in this scenario, each equity owner will take out life insurance policies on their co-owners and list themselves as the beneficiary to fund a buy-out triggered from the death of a partner. A simple illustration is set forth on the following page.

The key element of a cross-purchase agreement is that the facilitation of the repurchase of an equity owner's interest in the enterprise occurs completely outside the company itself. As will be discussed further in Chapter III, there are no direct ramifications to the company, tax or otherwise, as a result of a transaction occurring by the mechanics of such an agreement.

Caution: As will be noted in Chapter III, there may be a need to push more corporate income and cash flows to the remaining equity owners to fund the purchase of the departing equity owner's interest.

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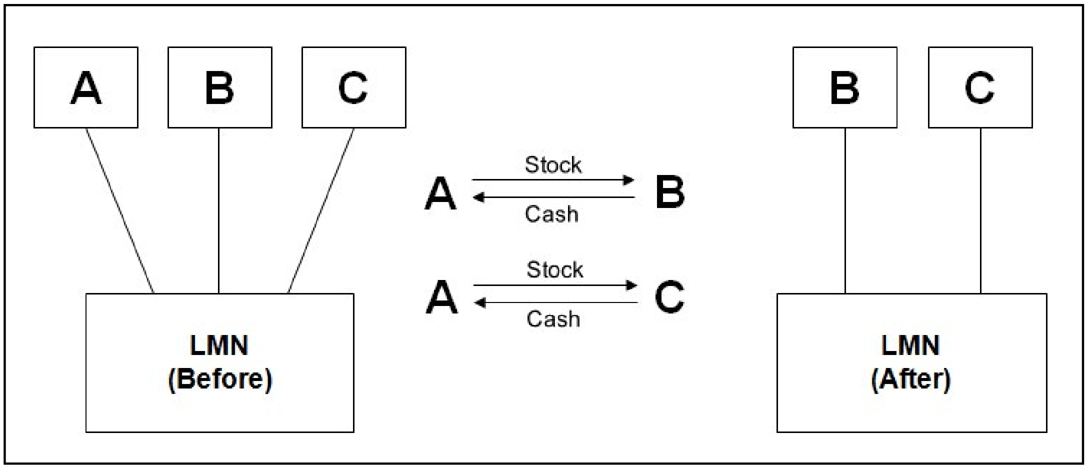
ILLUSTRATION: CROSS-PURCHASE AGREEMENT

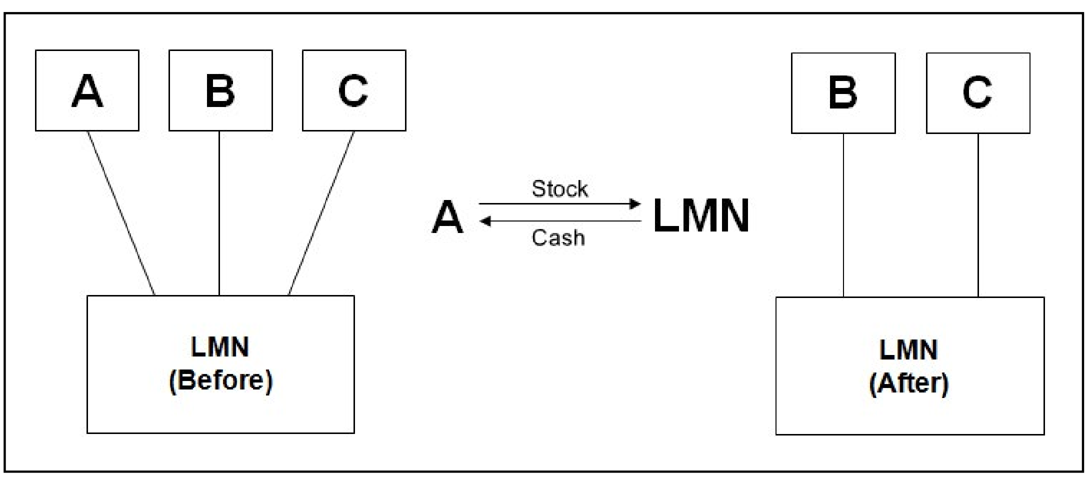


Entity Purchase or Redemption Agreements

Under this type of agreement, the business itself is obligated to purchase a departing owner's interest, and the business entity often purchases life insurance policies on each co-owner. This would allow for the owners to avoid making out-of-pocket payments. A simple illustration is set forth below.

Unlike a cross-purchase agreement, this structure moves the facilitation of the repurchase of the departing equity owner's interest to a company/enterprise-based transaction. Though occasionally labeled an "entity purchase agreement," these type of agreements are more-commonly referred to as "redemption" agreements. As will be further discussed in Chapter III, redemption transactions can have broad and complicated tax implications.

ILLUSTRATION: ENTITY PURCHASE OR REDEMPTION AGREEMENT



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Mixed or Hybrid Agreements

A combination of the first two types, this agreement is designed to give flexibility when a buy-out is triggered and allows either the business or business owners to purchase the departing owner's interest. The arrangement allows for the owners to determine whether it would be more advantageous for the business itself or the co-owners to buy-out the departing owner's equity interest.

Mixed or hybrid agreements are typically structured for the company to have the "right of first refusal" to purchase the departing equity owner's interest upon the occurrence of a trigger event. If the company declines to purchase the equity interest, it may be afforded the right under the agreement to offer the equity interest to the other owners on a pro rata basis. Alternatively, the company may carry the right to offer the departing equity owner's interest to a specific remaining equity owner or a group of remaining equity owners.

Often, this type of agreement gives the company a final chance to purchase the departing owner's equity interest in the circumstance that the company first refused to buy the equity interest and later found that the remaining equity owners declined to personally purchase the equity interest. Such rights are generally included in the agreement to ensure that the original ownership group is preserved and that care is taken to exclude new and unknown outside investors who might otherwise purchase the departing equity owner's interest.

Critical Elements of Buy/Sell Agreements

From the general definition and narrative set forth above it should be clear that a number of complex matters are relevant to the preparation of a quality buy/sell agreement. Among these matters are the following critical elements for consideration.

Selecting the most appropriate type of agreement

It is important to select the type of agreement that the equity owners deem most appropriate for the company and their specific circumstances. The three distinct options will be discussed at length in Chapter III.

Setting restrictions on transferability of the equity interests

A primary goal of most buy/sell agreements is preservation and maintenance of the original ownership group. As such, the agreements should incorporate provisions to ensure that equity owners have a capability to market and sell their ownership interests while protecting the integrity of the original ownership group as best possible. To be sure, the composition of any founding equity ownership group is likely to change over time, but the motivation at the creation of the buy/sell agreement should be to preserve that group and to allow that group (by virtue of the agreement) the flexibility to be selective as to the admission of new equity owners.

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Identifying the events that invoke the provisions of the buy/sell agreement

It is incumbent upon the equity owners and advisor team assisting with the development of the agreement to carefully and precisely define those events, commonly referred to as "trigger events," that cause the buyout provisions of the agreement to activate and guide departing equity owner transactions. Maintaining an environment that allows for orderly continuation of business operations should be at the forefront when planning for the inclusion of these events in the agreement.

Most often, these trigger events include death, disability, default and divorce. However, it is not unusual to observe the inclusion of a sale of an equity owner interest triggered by termination of employment, both voluntary and involuntary, and attempts to voluntarily or involuntarily transfer the equity ownership interest of an equity owner. Note that the term divorce, can include a divorce from a spouse as well as divorce from the business, itself. A well-written buy/sell agreement will include consideration of both types of divorce.

Note that common practice offers business enterprises and equity owners three specific options for facilitating the acquisition of departing equity owner's interests:

1. The use of mandatory buy/sell obligations between the parties to the agreement,
2. Non-mandatory options to purchase departing equity owner interests, and
3. Inclusion of a "put option" that requires the business or, alternatively, its equity owners to purchase the selling equity owner's interest.

The put option allows the departing equity owner the opportunity the force those parties that represent the potential buyers to purchase the equity interest.

Whether a purchase provision within the buy/sell agreement constitutes a mandatory or voluntary buy-out will depend upon the nature of the trigger event. Death as a trigger event is most often set forth as a mandatory obligation of the parties to the buy/sell agreement. Such a provision guarantees a reasonable and ready market for the deceased equity owner's interest, while ensuring that the estate receives fair consideration and has appropriate liquidity to facilitate the administrative directions and pay the tax and other obligations of the decedent.

The advantages of a mandatory death trigger include allowing the business and the remaining equity owners to continue to operate the business as it has been historically run without interference from the estate and protecting the equity ownership group from the admission of an heir of the decedent. Finally, life insurance allows for clear and ready funding to facilitate the terms of the buy/sell agreement.

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Disability, on the other hand, is more difficult to address in buy/sell agreements. Providing for a purchase of the disabled individual's equity ownership interest in a buy/sell agreement offers that individual an opportunity to sell his or her interest in a ready market and at a fair price. This opportunity can be critical to the disabled individual and his or her family, as the disability is almost certain to reduce earnings from employment during the period of disability. From the perspective of the company, such a provision is necessary to ensure that the business can continue to operate as it has in the past given the limitations of the disabled party to contribute to the success of the enterprise going forward.

Generally, partial or temporary disability is addressed in buy/sell agreements as a voluntary trigger event. By providing the parties with an option to buy the disabled individual's ownership interest but not requiring a mandatory purchase, the disabled individual is afforded an opportunity to return to work in the future.

Long-term disability is treated somewhat differently. In these instances, it is likely that the disabled individual will encounter significant financial difficulties. For that reason, many buy/sell agreements set a put option, which is actionable in the event of a long-term disability. Generally, there is an extended period of time (from one to as many as five years) between the occurrence of the disability and the permissible exercise date for the put option. This type of deferred trigger event not only allows the disabled equity owner to arrange for financial security, but also provides a planning period for the remaining equity owners to prepare for the purchase.

Default is an event that should also be included in the buy/sell agreement, with consideration most often given to the benefit and favor of the business, itself. Examples of trigger events included in this category include:

- Bankruptcy, insolvency, or any assignment undertaken for the benefit of creditors
- Any attempted transfers to outside third parties
- Proposed transfers to divorced spouses
- Criminal activities, including fraud, misappropriation, or embezzlement or misuse of business assets

The purchase of an equity ownership interest from an owner due to default for any of these reasons should be optional to the business and/or its ownership group. Such an option will allow the equity ownership group, and the company, to avoid intervention from any outside authorities/overseers that might otherwise be interested in disturbing daily operations.

Divorce, as noted above, includes both personal divorce from a spouse as well as a divorce from the business and its remaining equity owners. In certain cases, a divorce among the business owners may be voluntary,

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allowing for such trigger events to operate in a cordial fashion. Retirement or voluntary termination of employment are other circumstances that allow for a voluntary purchase of the retiring equity owner's interest. On the other hand, an involuntary termination of employment is probably best set out as a mandatory purchase of that equity owner's interest.

One extraneous circumstance that often causes unruly outcomes can result from cases when the company has equal ownership, and the equity owners are deadlocked in their opinions as to how best to move the business forward. In these instances, the buy/sell agreement should give all equity owners the right announce to the other owners his or her intention to either buy one or more of the equity ownerships interests of the other owners or require the other equity owners to purchase his or her shares. The remaining equity owners then choose to sell their equity interests to the announcing equity owner or, alternatively, purchase the announcing equity owner's interest.

The listing of trigger events should be as specific as possible. The authors have often noted instances of controversy arising from questions as to whether the buy/sell agreement in place applied to a specific event. These types of issues can easily be avoided with more careful assessment of both required and desired trigger events at the outset and the inclusion of these events in the final agreement.

Establishing a definition of value for the equity interests and those procedures necessary for valuation

Often given limited focus by crafters of buy/sell agreements and business owners, perhaps no matter is more crucial in developing a useful and complete agreement than setting the parameters for the determination of value. Obviously, the value determination will ultimately lead to the "purchase price" of the equity owner's interest and, likely, the exit or deal consideration. While such a determination is extremely critical to the departing equity owner, it is no less critical to the remaining equity owners and the company, as one or the other is likely to be acquiring that equity interest and will require funding.

From the author's perspective, most controversy in the arena of buy/sell agreements arises from poorly crafted provisions setting forth the valuation determinations. While many companies have little or no value at the date of inception, one need only look to the Arizona Tea case discussed in Chapter I of these materials to understand that value starts to change immediately upon the start-up of any business. Failing to properly address this complex matter fully and articulately will almost certainly leave room later for challenges to the definitions set forth in the agreement, the approaches and methodologies employed in making a determination of value and in the resultant value conclusions.

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Setting terms of payment by which the departing equity owner will be paid

The most critical element of the provisions governing payment for any departing equity owner's interest is whether the payment will be made in a single lump sum payment at a specified closing date or whether the purchase price consideration will be paid over a term via installment payments. Both methodologies are common, and there is no right or wrong answer to this issue. Generally, payment over an extended period of time using installments offers the buyer more flexibility in planning for the cash flow requirements of the transaction. On the other hand, settling the purchase of the departing equity owner's interest using installment payments adds risks, including the time-value of money, for which he or she is likely to want some form of enhanced security as well as interest on the deferred proceeds. The perception of security risk rises, of course, with a longer payment period.

Another common provision surrounding this particular issue is one addressing the departure of multiple equity owners within close proximity in time to each other. The authors have observed, especially in terms of entity purchase or redemption agreements, provisions setting forth a "cap" on the maximum amount of entity cash flow that might be used in any year to fund the repurchase of its equity. To better understand this issue, consider the following example.

- Assume that a departing equity owner is having his/her stock redeemed by a corporation for $1,000,000. The agreement notes that the proceeds are to be paid with $200,000 at closing and at the end of each 12-month period thereafter for four additional years.
- Assume further that in Year 2, a second departing equity owner decides to leave under the exact same value and payment terms. In each of the Years 2, 3 and 4, the total cash outflow expended for the redemption of its shares by the company will be $400,000.
- If the entity cash flows are such that these payments do not cause any unusual duress for the company's operations, there is no problem. However, if the maximum amount of cash flow that can be utilized in the redemption of its shares each year is only $300,000, it may be necessary to cap total payments due all departing equity owners at $300,000.

It is usually a prudent decision to determine the maximum amount of cash flow available for such redemptions and make allowances for these limitations in the agreement. As business value as well as operational cash flows grow, this threshold will change.

Setting forth the funding mechanisms from which payment may be made

Making a determination at the creation of the buy/sell agreement as to where funds are likely to come from for purposes of funding the equity purchases of departing equity owners is as important as the valuation and the payment terms themselves. Of course, payments required because of the death of an equity owner are most often funded with proceeds received from a life insurance policy on the deceased equity owner. No other circumstance is so easily funded.

A common mistake that the authors have observed is maintaining life insurance policies to fund the equity ownership interest transfer in the event of death, but not allowing for a purchase of an equity owner's interest in the case of disability. This can be a particularly devastating circumstance where the disabled individual is, or has been, critical to the company's operational success. Obviously, the loss of the incapacitated equity owner's contributions to the operational success of the company will not only reduce the value of the enterprise going forward, but will also limit its capability to generate the very cash needed to fund the repurchase of the equity interest held by that owner. There are insurance options for disability, but the cost benefit of such policies requires careful assessment.

In most circumstances, other than death and, perhaps, disability, funded by insurance, the funding of such repurchases will likely require current and ongoing entity cash flow. Such a funding plan is particularly expensive, as the acquisition of the departing equity owner's interest offers no immediate tax deduction and corresponding tax benefit. This tax treatment bodes for the more common consideration of paying for the departing equity owner's interest over time through the use of installment payments, easing the cash flow burdens on the company.

Setting forth the means for dispute resolution

Even with a carefully crafted buy/sell agreement, owners may dispute over a number of issues. The buy/sell agreement may address how owners can resolve their differences without a lengthy, expensive battle which could disrupt or destroy the business. Specifically, the agreement can provide binding procedures for resolving disputes in a cost-efficient and less time-consuming manner including mediation, private arbitration or other alternative means to which all parties agree upon executing the agreement.

Having provisions in the agreement that handle dispute resolution is extremely helpful in minimizing costly litigation, keeping the nature of the disputes confidential (rather than resolving them in court) and creating a more efficient process, which will allow the remaining owners to return to running their business sooner.

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Sources of Buy/Sell Agreements

In the opinion of the authors, the primary, and best, source of a properly crafted buy/sell agreement is a team of professionals led, most often, by a practicing business attorney. The document is, first and foremost, a legal contract requiring an understanding of state business and contract law. Moreover, many of the very specific provisions within the agreement will require an in-depth understanding of legal terminology, as it is interpreted by jurisdiction. Further, legal authorship must work to facilitate the desires and consensus of the equity ownership group, while providing for a fair settlement with any departing equity owner in the future.

The other relevant team members may include an accountant who understands the tax, accounting and cash flow implications of the provisions of the agreement, a business valuator, as value is at the heart of every agreement and, finally, an insurance professional who understands business matters and the nature of buy/sell agreements. Together, this team can capably serve the clients by providing a logical, complete and articulate agreement that allows for minimal operational and business disruption at the departure of any current equity owner and, at the same time, meets the desires and wishes of each of the equity owners, departing and remaining.

Buy/Sell Agreement Templates

An internet search for "buy/sell agreements" can identify a multitude of online resources for templates, and attorneys can also utilize a number of legal publishing sources that set forth a general framework for documents such as buy/sell agreements. In a business environment where time is money and billable hour rates are exceedingly high and always increasing, such resources can provide a reasonable basis and means for producing such documents. Templates have a place in the accounting, tax and business valuation arena, as is the case for those practicing in the legal profession.

The issue with using templates is primarily with the age of the template and whether the information set forth in the template has been regularly and jurisdictionally updated. Many of the available templates for all facets of work are subject to outdated definitions and a general "non-responsiveness" to current developments affecting the subject of the template. Templates for buy/sell agreements are no different, and the authors would caution that great care be exercised when using these as a base for drafting such agreements.

In Conclusion

The proper preparation of a buy/sell agreement will begin with a careful assessment of the available structures and continue through to funding mechanism based on the value determinations and the terms under which the payments will be made to the departing equity owner. Chapter III turns to issues related to structure and funding, while Chapter IV will address the many complications related to valuation.

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III. Structure Considerations

As noted in Chapter II, there are two primary types of buy/sell agreements as well as a hybrid model. With a cross-purchase agreement, each equity owner of the business entity is provided a right to acquire all, or a portion, of the departing equity owner's ownership interest.

Most often, the primary trigger event which poses the greatest concern in a buy/sell agreement is the death of an equity owner. In these instances, it is common to use life insurance as the most appropriate vehicle by which to acquire the equity ownership interest held by the decedent. To fund the purchase, when the trigger event is death, members of the equity owner group each purchase an insurance policy on the other equity owners.

Under this type of arrangement, each purchasing equity owner is both owner and beneficiary of the policies. Upon the death of an equity owner, the other equity owners are then able to use the life insurance proceeds to purchase the deceased owner's equity interest.

The second commonly used type of buy/sell agreement is an equity redemption agreement, in which the corporation owns policies on the lives of the equity owners. In these instances, the corporation will acquire the equity interest of the decedent. When a shareholder dies, the corporation buys the deceased shareholder's equity ownership interest in the company with the insurance proceeds.

Note that in both types of plans, the general planning dictates that proportionate equity ownership will remain consistent both before and after the purchase transaction.

The cross-purchase agreement provides that all remaining equity owners will acquire their proportionate shares of the decedent's equity ownership interest. Thus, the decedent's ownership interest is, in effect, divided among the remaining equity owners in proportion to the remaining equity ownership after the acquisition of the decedent's equity ownership interest.

For illustration, consider the following example of the mechanics of a cross-purchase agreement:

- Assume a company is owned by five equity owners, A, B, C, D and E, who each hold a 20% ownership interest in the company.
- Assume that E dies. At that point in time, each surviving equity owner holds his or her 20% interest.
- The total remaining percentage held by the ownership group is 80%, and each of the four remaining equity owners will acquire 25% (20% / 80%) of the equity interest held by E at his death.
- Each of the remaining equity owners will see their ownership percentage increased to 25% as a result of the proportionate purchase of the decedent's equity interest.

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Alternatively, in an equity redemption agreement, the company will reacquire the interest from the decedent and hold that equity in its treasury or retire the interest. In this case, the remaining equity owners, A, B, C and D, each own their original 20% interests. However, since the equity interest acquired by the company reduces the "outstanding" equity to 80% of what it originally was, each of the four remaining equity holders owns 25% of the outstanding equity interests.

Cross-Purchase Agreements

The cross-purchase form of the buy/sell agreement offers several significant advantages that should be taken into consideration when drafting a buy/sell agreement. The remaining equity owners will have a tax basis equal to their "cost," presumably the amount they each pay for the equity interest of the departing equity owner. The cost basis should reduce future income taxes if the remaining equity owners later sell their interests.

If the trigger event is caused by death of an equity owner, the value of his or her equity interest will be its fair market value at the date of death. As such, any purchase of that equity interest will, in effect, be "tax free" to the departing equity owner's estate or heirs. As will be discussed in Chapter IV, the fair market value of the equity interest should be defined within the buy/sell agreement.

The life insurance proceeds received by the surviving equity owners are not subject to income taxation. Further, the insurance proceeds are not subject to the corporate alternative minimum tax (AMT), nor to the claims of corporate creditors. The AMT avoidance and creditor protection exist because the proceeds are paid directly to the individual equity owners.

While there are advantages to using the cross-purchase form of a buy/sell agreement, the news is not all good. The cross-purchase form of the buy/sell agreement also carries several disadvantages, including difficulty in administering the plan if there are numerous equity owners who are afforded the opportunity under the agreement to buy a departing equity owner's interest as a result of the occurrence of a trigger event.

In particular, if equity owner death is a trigger event (and, it always is), each equity owner must buy an insurance plan for the others. As an example, for eight owners to cross-purchase life insurance, it would require 56 (8 x 7) policies. The number of policies would be even greater if disability coverage is also part of the buy/sell agreement.

Another commonly encountered disadvantage of the cross-purchase agreement structure is that age or insurability can create a disparity in the cost of insurance and the required premiums. Under such a structure, younger or healthier owners can incur higher insurance premiums to cover older and less-healthy equity owners.

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One possible solution to this drawback, though full of complexity, itself, is to have the company raise salaries/guaranteed payments to cover the insurance premiums incurred by the equity owners. Even with this type of arrangement, inequities may still persist, if the equity owners' marginal tax rates applied to the salary/guaranteed payment reimbursements are different. This is not an easy strategy to implement as income tax "gross ups" are integral to the analysis and are likely to differ from one equity owner to another. In addition, for equity owner groups adopting a cross-purchase agreement structure, it must be understood that the cost of funding the buy/sell agreement will be greater if the equity owners have a higher tax rate than the company.

Note, that under current tax law as of the date of this presentation, the highest individual marginal income tax rate is 39.6%. Corporations are taxed at 35%. However, in Pennsylvania, the state rate for individual taxation is 3.08%, while the corporate rate is 9.99%.Tax-affecting the state rates for the federal income tax benefit of any deductions results in an astoundingly close combined federal and state income tax rate comparison for tax planning purposes. However, such is not always the case, and these issues must be carefully considered in the event that there is contemplation of using greater salaries/guaranteed payments to fund the insurance.

Equity Interest Redemption Agreements

Under an equity interest redemption agreement, the company is granted the right to acquire the equity ownership interest of the departing equity owner. Generally, the acquisition of an equity owner's interest at the occurrence of a trigger event under this type of structure is treated as a "redemption" of that owner's interest.

If the obligation to purchase an equity interest granted under the equity redemption agreement is to be funded with life insurance, the company is the owner of the policies on the lives of the equity owners. When an equity owner dies, the company then uses the life insurance proceeds to purchase the equity owner's interest in the company. This option offers the advantage of a simpler administrative process by placing responsibility for the acquisition of the departing equity owner's interest with a ***single*** buyer, i.e., the company.

Further, another important advantage to the equity redemption structuring of the buy/sell agreement is that the company bears the premium differences associated with age disparities among equity owners. However, even though the company bears the insurance cost, the fact that insurance costs associated with varying ages and degrees of insurability among the equity ownership group does, at the end of the day, provide economic benefit to all equity owners as it allows for the creation of a liquid market. Thus, the economic benefit to one equity owner of having this ready market, i.e., the availability of the insurance proceeds at death, will carry a different cost to the company based on age and insurability.

From a tax perspective, the company will not recognize income for tax purposes when it receives the insurance proceeds. The company, however, must comply with the tax rules for equity owner redemptions. In particular, corporations must consider the effect of the entire transaction (proceeds received and redemption accomplished) on the earnings and profits of the corporation. The earnings and profits will increase with the life insurance proceeds received and decrease as a result of the stock redemption. As such, the corporation must attend to the overall net effect on earnings and profits and consider how that might impact the dividend policy to shareholders. For example, in some instances, a corporation may have to issue dividends to avoid the accumulated earnings tax on earnings and profits, assuming that the reasonable needs of the business do not justify maintaining earnings and profits above the $250,000 credit set forth in Internal Revenue Code §535. These dividends would be taxed to the remaining shareholders at ordinary income rates, currently set at 20%.

Note, that a significant disadvantage of the stock redemption form of the buy/sell agreement is that the remaining equity owners do not receive the benefit of a step-up to the cost of the equity interest in their bases when the company purchases the deceased equity owner's interest. Moreover, there is no basis increase to the company in any equity interest repurchase. Generally, the cost of reacquiring equity from an owner is simply treated as a "contra-equity" matter.

As a result of this treatment, the remaining equity owners retain their original bases in the company. In comparison to the cross-purchase agreement, the equity interest redemption structure will create greater capital gains upon the ultimate disposition of shares if made before death of any of the remaining equity owners. After the equity owner redemption is accomplished, however, the company assets should be relatively unchanged – the insurance proceeds have been used to purchase the deceased owner's interest, but each owner now enjoys a greater percentage of ownership.

Estate Tax Considerations

When a cross-purchase structure is used, the deceased shareholder is not the owner of the policy and, therefore, the insurance proceeds payable at death are not included in his or her estate. However, if an equity interest redemption structure is adopted, the estate tax implications can become more pronounced. This is especially true when the deceased equity owner held a controlling interest.

Under Internal Revenue Code §267, an equity owner who owns more than a 50% interest, either directly or indirectly, is deemed to control a company. In this situation, the equity owner is "deemed" to have an ownership interest in the life insurance policy due to the attribute of control and that equity owner's ability to designate

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a beneficiary as well as other ownership interests. In instances where control exists over the insurance policy in majority ownership, the proceeds would be includable in the decedent's estate. Thus, the after-tax returns on life insurance policies can be substantially reduced if estate taxes are incurred as a result of the life insurance proceeds being included in the estate.

In the case of family-owned companies, purchase prices specified by buy/sell agreements are regularly challenged by the Internal Revenue Service as not representing fair market value. If a company owns life insurance for the purposes of funding the redemption of the equity interest, and the deceased equity owner held a controlling interest in the company during his or her lifetime, it is probable that the life insurance policy will be included in the decedent's estate. Note, however, that if the family members own the insurance policy on the decedent, they will receive the life insurance proceeds without including them in the taxable estate. In such cases, the cross-purchase option may be preferable to the redemption option.

With respect to setting the fair market value for any decedent's equity interest, the determination of value in any buy/sell agreement will only be respected by the Internal Revenue Service if the agreement is found to be bona fide. The IRS often takes the position that the actual value of stock in a closely held business owned by a deceased stockholder is significantly greater than the value of stock reported by the estate, resulting in substantially higher estate taxes owed by the estate. The worst case scenario is that the IRS successfully challenges the buy-out price. The estate would then find itself in the undesirable position of receiving a contractual agreement price for the shares that is lower than the valuation upon which it pays estate taxes.

Under Internal Revenue Code §2703, buy/sell agreements are disregarded for valuation purposes unless all the requirements discussed below are met. An important point about applying the tests of §2703 is that an agreement is deemed to meet all three tests if it is between people who are not members of the transferor's family, and if non-family members own more than 50% of the value of the subject property.

- ***The agreement must constitute a bona fide business arrangement.*** This test is not very difficult to pass. For instance, reasons found valid include (1) maintaining current management policies, (2) maintaining exclusive family control, and (3) retaining key employees.

- ***The agreement must not be a device to transfer property to members of the decedent's family for less than full and adequate consideration.*** In order for a buy/sell agreement to meet this test, which traces its roots to Reg. 20.2031-2(h) and a plethora of cases, two requirements must be satisfied.

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- First, the buy/sell agreement must not be designed to serve a "testamentary purpose." Factors considered in determining whether a buy/sell agreement has a "testamentary purpose" include:
  - Whether the decedent was ill at the time of entering into the agreement;
  - Whether there were extensive negotiations prior to entering into the agreement (as opposed to a parent dictating the terms of an agreement with his or her family, such as in *Estate of True, Jr.*);
  - Whether the agreement is consistently enforced with respect to other transactions involving company interests;
  - Whether the buy/sell price was formulated based on comparables or appraisals (rather than a formula chosen for "convenience," as the courts held in *True* and *Estate of Lauder*);
  - Whether the drafters of the agreement sought professional advice in selecting the formula price;
  - Whether the agreement requires that the price be periodically reevaluated;
  - Whether significant assets (such as goodwill) are excluded from the formula price; and
  - Whether the agreement provides for below-market payment terms for the purchase of a decedent's interest.
- Second, the formula for establishing the purchase price of interests subject to a buy/sell agreement must be fair. In general, courts evaluate fairness as of the date that an agreement is executed, rather than the date of a decedent's death. The courts normally presume that unrelated parties to a buy/sell agreement will negotiate a fair formula. However, agreements between related parties (parents and children in a family-owned business) are subject to special scrutiny – the estate of a deceased shareholder may be forced to prove that the formula price will not result in an amount that is lower than what would be agreed upon by persons with adverse interests dealing at arm's-length. In *Lauder* and *True*, the court disregarded book value set forth in buy/sell agreements between related parties for estate tax valuation purposes.

• ***The agreement must have terms comparable to those of similar arrangements entered into by persons in an arm's-length transaction.*** The last test of §2703 can generally be met if the agreement could have been obtained in a fair bargain between unrelated parties or if the restrictions conform to standard practice in the business. A problem in analyzing whether this test is met is that most buy/sell agreements are negotiated to address unique facts and circumstances and are not public documents.

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Funding Buy/Sell Agreements with Insurance

The selection of an insurance funding mechanism in the course of planning for buy/sell agreements requires a decision regarding the type of insurance policy to purchase. Generally, the initial choice is between term and whole life insurance. Premiums for term life insurance increase during the coverage period, whereas, premiums for whole life are level throughout the coverage period. If the shareholder dies in the first few years of coverage, the cost of term insurance will be less than the cost of whole life insurance. Conversely, the cost of term life may be much greater than whole life if an individual exceeds the life expectancy used for underwriting the policies.

Whole life insurance with cash value buildups can offer advantages. If policies are held for a significant number of years, the cash values of whole life policies can supplement pension benefits or help fund shareholder buy-outs. Additionally, the policy's cash value is a liquid asset of the corporation, which may help secure advantageous loan terms for the company.

Shareholders may choose to forgo whole life insurance and purchase term insurance. The early premiums saved may be invested in the company to either reduce debt or promote growth. In favorable economic conditions, the return on investment will typically be greater than the earnings attributed to the cash value of the whole life policy. The possibility of premium savings in the event of premature death and the excess expected returns on premium differences invested are advantages for term insurance.

In addition to cost, insurability is a key consideration. The ability to maintain life insurance throughout a shareholder's life is important. Because whole life insurance policies grant coverage until death that may not be cancelled by the insurance company, whole life insurance is often considered as the proper means to finance corporate buy/sell agreements. However, the term life insurance industry has modified its products so that policyholders can enjoy the same benefit, through either a guaranteed insurability option or lengthy (20- to 30-year) policy terms. The addition of a guaranteed insurability option to a term policy will increase the cost of the term insurance. The increased premium, however, will still be lower than whole life premiums in the beginning years. Owners, therefore, must weigh the escalating premium structure of term insurance against the early returns that might be realized by purchasing less-expensive term insurance and investing the premiums saved.

With time, the value of a successful company is expected to grow. Assuming the buy/sell agreement correlates purchase price to fair market value, equity owners should ensure that additional life insurance can be acquired over time to keep pace with the increasing value of the company's equity interests. Typically, guaranteed insurability options allow the policyholder to acquire additional life insurance (whole or term) at timed intervals.

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Note when an equity owner dies, several issues arise with respect to policy ownership by the deceased and the remaining equity owners in the cross-purchase structure. The policies insuring remaining equity owners, but owned by the deceased, will carry beneficiary designations, generally family members. With whole life, the family inherits the cash surrender value of the policies. With no continued business purpose, and out of courtesy to the surviving equity owners, the surviving family beneficiaries may choose to cash out the value of the policies.

Also important is how the transaction under a cross-purchase structure affects value (or rather, how it does not affect value.) Under a cross-purchase approach, the death of a company equity owner will not dilute the value of the ongoing company. Because individuals, and not the company, hold the life insurance policies, the receipt of death benefits or cash values by the policy beneficiaries will not decrease the assets of the company. All aspects of a transaction consummated under a cross-purchase arrangement manifest outside the company.

This fact does, however, create a funding issue for the remaining equity owners. The remaining cross-purchased policies will likely not cover the continuing value of the business. The remaining equity owners may need to address the shortfall by purchasing additional insurance if other funds are not readily available.

An alternative to purchasing additional insurance would be to use term life insurance to fund the buy/sell agreement. The value of a term life policy is normally equal to the unearned premium for the year of death, usually very small in comparison to whole life insurance. Given this low value, equity owners might consider purchasing term insurance as joint tenants with rights of survival. The insurance policies could transfer from the deceased to the remaining equity owner without triggering recognition of income upon the death of the insured.

Funding Buy/Sell Agreements without Insurance

Equity owner groups that elect not to fund departing equity owner settlements with life insurance typically expect that all funding will come from cash flows generated by the company. In such situations, companies organized as C corporations ("regular" corporations, subject to tax at the corporate level) often must pay dividends to avoid the corporate accumulated earnings tax. Alternatively, corporations may elect S status, whereby earnings flow through to shareholders and are then taxed at the individual shareholder level. Either way, shareholders will likely incur increased taxes.

Regardless of the corporate form, earnings may be strategically accumulated so they can fund needed buy/sell settlements. When the company invokes the provision of the buy/sell agreement due to the death of an equity owner, the estate of a deceased equity owner will still receive the proceeds for selling the equity ownership interest without incurring income taxes (as noted earlier, the equity interest basis share basis will be the fair market value at the date of death.)

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Alternatively, if the buy/sell agreements are invoked for any other trigger event or reasons other than debt, such as a departure of an equity owner at his or her date of retirement, the departing equity owner will not receive the basis "step up" accorded decedents; however, they will benefit from capital gains treatment.

A critical assessment, as noted in Chapter II, is the availability of sufficient cash flow to honor the provisions of the buy/sell agreement. The agreements should specify an installment purchase option (rather than the immediate purchase of shares) where time might be needed to accumulate funds for the redemption of the stock (e.g., upon the sudden death of a shareholder.)

The actual funding of the equity owner buy-out in those instances where insurance is not used as the funding mechanism, and cash is not available to facilitate the purchase of the departing equity owner's interest, is essentially limited to obtaining departing (selling) equity owner or outside financing and the use of a "sinking fund." However, given the fact that contributions to a sinking fund are not tax deductible, the accumulation of cash to facilitate a future equity owner buy-out is inordinately expensive. Rarely used, sinking funds have become somewhat passé, as better and more critical needs are identified for operating cash flow take precedent.

Outside financing can be a trying process. Perception as to the equity valuation without the departing equity owner's presence, the collateral position of the company and overall creditworthiness of the company can all serve to prevent effective use of outside financing. As noted throughout these materials, seller financing (i.e., deferred payments from operating cash flows) is most often the only available funding mechanism for cases in which the trigger event cannot be funded with insurance.

Combination Funding of the Buy/Sell Agreement

Generally, the authors have observed a combination approach to funding buy/sell agreements where equity owners choose to have a portion of the buy/sell agreement funded with life insurance to guard against premature deaths, while funding the remainder from future operating free cash flows and corporate profits.

As an example, equity owners could initiate a buy/sell arrangement to purchase 80% of the equity interest through a cross-purchase agreement (with funding provided by life insurance), and 20% of the equity interest would be redeemed by the company upon the death of an equity owner.

Alternatively, shareholders may elect to initially fund 100% of the buy/sell agreement with a cross-purchase structure funded by insurance. The funding of the agreement can then change annually, with the company assuming responsibility for purchasing any incremental increases in equity owner value as the company grows.

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This type of approach eliminates the need for equity owners to periodically increase the amount of life insurance over time. It also provides assurance that an equity owner's family will receive a minimum amount of cash, whether or not the company can generate the additional funds necessary to honor the buy/sell agreement.

Such a combination approach may be especially useful in planning for family corporations. Federal tax law limits the amount of stock purchased by the corporation that can be classified as a redemption instead of as a dividend. The limit is the sum of the estate, inheritance, legacy, succession taxes, generation-skipping taxes, and funeral and administrative expenses allowable as deductions to the estate of the deceased.

Share value in excess of certain limitations imposed by Internal Revenue Code §303 may be purchased with life insurance proceeds. The basis of this purchase will be the fair market value of the shares at the date of death. To remove the value of the remaining shares from the deceased shareholder's estate free of taxes, the buy/sell agreement should provide a member of the family an option to buy the stock from the estate. The family member may then choose to exercise the right to purchase remaining shares, as determined by the Internal Revenue Code §303 limitations. The combination approach (part corporate redemption, part family member purchase) can result in the total value of the deceased's corporate shares being extracted from the estate without income tax consequences.

The details of such a strategy are beyond the scope of today's presentation. Note, however, that the case law supporting these outcomes is set forth in *Estate of James J. Durkin, Sr.*, 99 TC 561 (1992) and *Zenz v. Quinlivan*, 213 F2d 914 (6th Cir. 1954), which indicate that the taxpayer must not be obligated to purchase the stock.

In Conclusion

The technical implications of choosing a buy/sell agreement structure that most appropriately fits the needs of the members of the equity ownership group must be considered carefully at the inception of the agreement. Further, as the agreement is only as useful as the parties' capabilities to honor the terms and funding requirements set forth therein, it is critically important that focus on this important area be undertaken as the document is drafted. And, finally, as equity interest values are clearly going to fluctuate over the life of any business and, hopefully, increase over time, periodic determinations of value and resultant additional funding needs must be taken into consideration.

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IV. Valuation

As noted previously, the issue of valuation is often at the forefront of buy/sell agreement controversy. The authors of these materials have observed fundamental equity owner misunderstandings regarding a number of valuation matters including definitions, business valuation procedures and protocols, professional standards, appraiser qualifications and what the appraisal process is intended to do "as it is spelled out" in the buy/sell agreement.

Much of this misunderstanding is rooted in the lack of equity owners' focus on these matters at the document's creation (most often at inception of the business) and a failure by financial and legal advisors to properly advise equity owners on these matters at that time. The problem is compounded by the passage of time and a changing business and professional environment where evolution of such documents is critical to their overall effectiveness. If buy/sell agreements remain as they were drafted years, or decades, before, without attention to periodic updates, it should be expected that the document is less likely to contain the appropriate language at an equity owner departure. It is no surprise in these cases that controversy is the most common outcome.

To facilitate the development of a well-crafted buy/sell agreement, it is important to understand a number of basic business valuation concepts, which are described further in the following sections. Understanding these key concepts and incorporating them into a buy/sell agreement can save significant time and money in the future.

Standard of Value

Standards of value are nothing more than definitions of value. The standard of value is simply a description of the "type of value" that is called upon by the buy/sell agreement. Misunderstanding the appropriate standard of value is often at the root of buy/sell agreement controversies. A great deal of confusion in requesting a business valuation for these purposes, or interpreting its meaning, could easily be avoided by properly focusing on the selection and utilization of the appropriate standard of value.

If directed by the agreement, the standard of value can be dictated by the Internal Revenue Code.[7] On other occasions, the standard of value set forth in the buy/sell agreement may have evolved through judicial decisions and guidance issued by governmental regulatory agencies and authorities. Often, the appropriate standard or definition of value can be found in the *International Glossary of Business Valuation Terms*, which sets out the most common terminology and widely accepted definitions, as used by the appraisal profession.[8]

[7] Unless noted otherwise, all references herein to "the Internal Revenue Code" or "the Code" is intended to reference the United States Internal Revenue Code of 1986, as amended and included under Title 26 of the United States Code.

[8] *International Glossary of Business Valuation Terms*, released in 2000, is adopted by the American Institute of Certified Public Accountants, American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts and the Institute of Business Appraisers.

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The authors recommend that the definition of the standard of value begin with reference to the *International Glossary of Business Valuation Terms*, with supplemental explanatory language added to ensure that all parties are fully cognizant of the intended meaning. This thorough approach should leave little room for misinterpretation in the future when the buy/sell agreement becomes operative due to the occurrence of an applicable trigger event.

In any case, the critical mandate is to carefully define value and to ensure that all parties to the agreement fully understand the implications of using the selected standard of value. Understanding the various standards of value is not overly complex. However, it is incumbent upon the business valuator and the user of his/her work product to fully understand the ramifications and implications of each definition.

Attorney Guidance: While it is generally the role of the business valuator to fully explain and educate counsel as to the definition and nuances of each standard of value, it is generally the role of the attorney and the equity ownership group to determine the most appropriate standard of value to include in the buy/sell agreement. This is especially true where judicial history subject to legal interpretation sets the precedent.

At the end of the day, years after the initial crafting of the language of any buy/sell agreement, a business valuator/appraiser is guided solely by the language in the agreement. Oftentimes, equity owner remorse (in both directions) arises because of frustrations resulting from a misunderstanding of the terminology, and specifically the standard or definition of value, as it is set forth in the agreement.

The standards of value most commonly encountered by business valuators and users of business valuator work product are detailed below. Each type of value has varying nuances and economic attributes that might make it applicable to a certain company and equity ownership group while, at the same time, inapplicable to another. The essence of the determination as to which standard of value should be used in a buy/sell agreement should be that standard of value that most closely captures the needs and intentions of the equity ownership group at the date of the buy/sell agreement. The complexities associated with fully understanding the standards of value often requires detailed advisor input from both legal counsel and the business valuator.

Fair Market Value

By far, the most common standard of value is fair market value. It is the standard of value that is applied in income, estate and gift tax, marital dissolution[9] and, often, non-shareholder oppression litigation.

[9] Many states use the term "fair market value" in their marital dissolution cases. The definition of fair market value may vary from state to state and will not necessarily be the same definition applied for federal tax purposes.

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The origins of fair market value are rooted in the Internal Revenue Code and supporting Treasury regulations, as well as Internal Revenue Service rulings. Its definition has been clear and sound for nearly seven decades. The term has been embraced from all within the business valuation community and is recognized in all major business valuation treatises authored by the profession's preeminent experts.

Fair market value is defined in the United States Treasury regulations [20.2031-1(b)] and Revenue Ruling 59-60, 59-1 CB 237 as:

… the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

Fair market value, is defined in the *International Glossary of Business Valuation Terms* as follows:

… the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted free market, when neither is under compulsion to buy or sell and both have reasonable knowledge of the relevant facts. [NOTE: In Canada, the term "price" should be replaced with the term, "highest price"]

This definition of value requires that the valuation result be driven by a hypothetical sale transaction. Given that the definition requires consideration of a hypothetical sale, it stands to reason, then, that focus and attention must be given by a valuator to those hypothetical buyers and sellers and the types of concerns and issues that a potential hypothetical buyer and seller might consider prior to entering into a transaction. Note that fair market value contemplates the entire universe of hypothetical buyers.

A key component of this definition is that a value determination based on special motivations of either a specific buyer or a specific seller would not be considered fair market value. Fair market value also anticipates that both the hypothetical buyer and seller have the ability, and willingness, to enter into the hypothetical transaction.

The key consideration in any determination of fair market value is that the hypothetical buyers include all possible buyers in the entire universe of potential buyers. As noted above, reference to any specific buyer with specific buyer attributes or motivations negates the key underlying element of fair market value. Focus within the valuation arena on a specific buyer shifts the standard of value from fair market value to investment value.

Fair market value is a "financial" value. As such, the definition of fair market value anticipates a value determination under prevalent economic and market conditions at a particular date of valuation. To assume an economic or market turnaround or other economic condition at a point in time beyond the date of valuation will result in a "hypothetical conclusion of value" rather than fair market value.

The definition of fair market value also assumes that payment in the hypothetical transaction will be made in cash or its equivalent at the date of valuation. Thus, consideration of any deferred financing or special purchase arrangement is not appropriate when the goal is to identify fair market value.

Fair market value, by definition, incorporates all economic risks associated with an investment in the subject equity interest. To that end, it should be understood by all parties to a buy/sell agreement that fair market value of fractional non-controlling interests (minority interests) is generally reduced by a discount for the non-control feature associated with that investment.

Finally, fair market value, by definition, must allow reasonable time for exposure in the open market. For equity ownership interests requiring longer periods of exposure, marketability, or rather the lack of marketability, presents a greater investment risk, and, therefore, a value detriment. Often this value detriment is addressed in the business valuation process as a discount for lack of marketability.

It is the authors' experience and observation that fair market value is that standard of value most often contemplated and used in buy/sell agreements. In combination with a going concern "premise of value" (discussed below), this standard or definition of value most closely aligns with the economic value of the equity interest being acquired from the outgoing equity owner.

Investment Value

Investment value is generally defined as the specific value of an investment to a particular investor or class of investors based on individual investment requirements and attributes (versus the entire universe of hypothetical buyers contemplated under fair market value.) In consideration of valuing an equity ownership interest, investment value differs from fair market value, which, again, is not buyer- or seller-specific.

Often, investment value is also referred to as synergistic or strategic value. This reference reflects the impact of those synergistic or strategic benefits that one particular buyer may bring to the negotiating table in determining investment value. Such buyer-specific benefits might include:

- An ability to enhance future operating performance,
- An ability to mitigate certain risks inherent in the subject company,
- An ability to more efficiently finance the acquisition of the subject company, and
- An ability to assimilate current operations synergistically with the subject company.

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In most instances, investment value will exceed fair market value. This phenomenon is primarily the result of the supply and demand continuum for target companies. Simply put, demand for acquisition targets far exceeds available supply. As competitive bidding progresses in the negotiation process, the marketplace reveals that prospective specific buyers are generally willing to pay a premium beyond fair market value to close the deal. Very often, these premiums are justified on a cost-benefit approach by considering such items as the "cost to create" the target business in its current state and geographic location, as well as the time that it might require to recreate the target business. Additionally, anticipated post-acquisition cost reductions due to operational synergies may allow for the payment of a premium.

It is noteworthy that the authors have never observed investment value (i.e., value inclusive of an acquisition premium for synergies, strategic initiatives or specific buyer attributes) paid for a fractional non-controlling or minority interest. Thus, it is the experience of the authors that such standards of value are rarely, if ever, used in conjunction with a buy/sell agreement.

Intrinsic or Fundamental Value

Perhaps the most difficult standard of value to grasp, intrinsic value, represents a specific analyst's judgment of value based on the perceived characteristics inherent in the specific or particular investment. The intrinsic value standard does not contemplate the specific motivations of a particular buyer, but rather, how that one analyst's perception of the characteristics attendant to the subject equity ownership interest compares to other analysts' perceptions.

An easy way to envision intrinsic value is to consider how it might apply to a capital stock investment. Essentially, intrinsic value is that value, based on the analyst's "fundamental evaluation" of all available information, which the analyst believes reflects the "true" or "real" worth of that stock. When all analysts perceive the stock's value as the same number, the intrinsic value moves to fair market value.

By way of example, assume that a stock of ABC, Inc. is selling for $25 per share. One analyst contacts you and suggests that the stock is underpriced and should be valued at $30 per share. As such, she advises that the stock is a bargain at that price and that you should buy the stock at $25. Once everyone comes to a conclusion that the stock is underpriced, the stock's value will eventually increase to attain the true value. At this point in time, $30 is the fair market value of the stock.

While intrinsic value is used sporadically in courts throughout the United States, and most often in marital dissolution proceedings, its overall use is extremely limited and rarely found in buy/sell agreements. The authors' have never observed the use of intrinsic value in a buy/sell agreement.

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Fair Value – Two Definitions

Fair value represents yet another standard of value. Adding confusion to this definition is the fact that there are really two very different applications (and, hence, definitions) of fair value. Thus, fair value really sets out two additional standards of value. The first is that standard of value used in various state courts to address alleged equity owner oppression matters and minority equity owner abuses by controlling equity owners, as well as dissenting equity owner actions. The second application is specific to accounting needs and financial reporting mandates issued by the Financial Accounting Standards Board (FASB), and as required by accounting standards.

Fair Value Under State Statutes

In most states, fair value is the statutory standard utilized to resolve shareholder disputes for both dissenting shareholder and oppressed shareholder lawsuits and civil actions. Thus, fair value is a legally created standard of value. Fair value, for these purposes, is generally defined, with respect to dissenter's shares, as:

> *…the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.*

While most states have a fair value statute, the majority of those offer little insight into its computation. It is noteworthy that state courts have not considered fair value for these purposes as being equal to fair market value. Generally, damages to the harmed party are determined by the difference between the value of the dissenting shareholder's percentage ownership interest before and after the corporation action, often without consideration of any discounts for lack of control or lack of marketability.

Again, it is the authors' experience and observation that "fair value" is seldom used in conjunction with the creation of buy/sell agreements. As will be discussed below, however, certain "hybrid" definitions of fair market value can often result in the determination of a conclusion of value more closely aligned with fair value.

Fair Value for Financial Reporting

The second type, or definition of fair value, is driven by accounting literature and guidance. As international accounting rules, including those currently used in the United States, move from a historical cost basis of accounting to a "fair value" basis of accounting, more attention has been focused on the definition of fair value for financial reporting purposes. Note that fair value for financial reporting has no relationship whatsoever to fair value under state statutes.

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Issued by the Financial Accounting Standards Board (FASB) in 2006, Statement No. 157 (SFAS 157) is effective for financial statements issued for fiscal years beginning after November 15, 2007. SFAS 157 is now referred to as FASB Accounting Standards Codification 820 (ASC 820) – *Fair Value Measurement and Disclosures*. This publication provides guidance on the measurement of fair value as a market-based measurement. The pronouncement includes a hierarchy for considering market-participant assumptions which outline and distinguish between sources independent of the reporting entity and the reporting entity's own assumptions.

FASB ASC 820 gives a single definition of fair value:

> *Fair value is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability.*[10]

It is clear from FASB releases that fair value for financial reporting is not fair market value. FASB ASC 820 expands on the difference between fair value and fair market value:

> *The Board agreed that the measurement objective encompassed in the definition of fair value used for financial reporting purposes is generally consistent with similar definitions of fair market value used for valuation purposes. For example, the definition of fair market value in Internal Revenue Service Revenue Ruling 59-60 (the legal standard of value in many valuation situations) refers to "the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.*
>
> *However, the Board observed that the definition of fair market value relates principally to assets (property). Further, the definition has a significant body of interpretive case law, developed in the context of tax regulation. Because such interpretive case law, in the context of financial reporting, may not be relevant, the Board chose not to adopt the definition of fair market value, and its interpretive case law, for financial reporting purposes.*[11]

The authors have never observed fair value from a financial reporting perspective as the standard of value in a buy/sell agreement. As such, these materials will include no further consideration of this standard.

Hybrid Standards of Value

Often, buy/sell agreements are drafted with some variation of the concepts set forth above in the various definitions, or standards of value. Such "hybrid" definitions can be acceptable but require careful wordsmithing to ensure that the terminology selected aligns with the desires and wishes of the parties to the agreement.

[10] FASB ASC 820 – *Fair Value Measurement and Disclosures* (formerly SFAS 157), paragraph 5.

[11] FASB ASC 820 – *Fair Value Measurement and Disclosures* (formerly SFAS 157), paragraph C50.

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One common example that the authors have observed in buy/sell agreements is the requirement that value be determined under a "fair market value" standard of value but that no consideration will be accorded a discount for lack of control (minority status) or for lack of marketability. Each of these discounts would generally attach to a fair market value determination of value for a non-controlling equity interest but would be excluded under such an agreement because of the special definitional language set forth in the agreement.

Exclusion of discounts aside, the authors caution that adopting a specific standard of value in the context of drafting a buy/sell agreement and then adding language to modify the standard definition requires great care and consideration at the outset of the business when the agreement is created. As noted earlier, business valuators, and the courts, will later be bound by the language in the agreement and years into the future, challenges to the determination of value will be limited to the definitions as they are set out within that document.

Premise of Value

Premise of value differs from standard of value. It is an equally important consideration to the determination of value and should be established and set forth in any buy/sell agreement.

The premise of value element describes the set of "assumed" circumstances under which the selected standard of value transaction will take place. In other words, if one assumes that the selected standard of value is fair market value, the premise of value will describe under what set of transactional circumstances the subject operating business assets will be exchanged between the hypothetical willing buyer and hypothetical willing seller.

There are numerous alternative premises of value that may apply to any particular valuation assignment. The five most common premises of value are:

- Value in continued use, as a going-concern business enterprise
- Value in place, but not in current use in the production of income
- Value in exchange, as part of an orderly disposition of assets
- Value in exchange, as part of a voluntary liquidation of assets
- Value in exchange, as part of an involuntary liquidation of assets

In most valuations, the subject company is an operating entity with an active deployment of business assets. In these instances, therefore, the premise of value is generally "continued use" or "going concern."

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Valuation on a going concern basis (that is, under a "going concern" premise of value) assumes that the company will continue to operate in the future as it is assembled at the date of valuation. In other words, an operating company has an assemblage of assets (net of liabilities) at any particular date of valuation. The successful deployment of those assets yield a certain level of expected future free cash flows. It is these free cash flows, then, reduced to present value by virtue of applying a risk rate to them that provides an indication of value.

Again, it is important to note that if the agreement adopts fair market value as the appropriate standard of value, the resulting value under this premise of value is a "financial value." Stated simply, financial value refers to the fact that the valuation is conducted with the same assemblage of assets (net of liabilities) after the date of valuation as it owned and operated on the date of valuation.

Major assumptions of any type affecting the estimate of future expected free cash flows nullifies both the standard of value and the premise of going concern.

One example commonly encountered is the desire by the departing equity owner to have his or her interest valued with consideration of strategic premiums when fair market value is the selected standard of value included in the buy/sell agreement. To do so presents numerous technical problems, not the least of which is the misuse of the selected standard. The synergistic premiums could only be realized and, therefore, justified, in a strategic acquisition where material modifications to the company's historical assemblage of assets and operations would take place by virtue of the business's combination with the acquirer. Thus, the valuation would be of something other than the company at the date of the valuation.

Further, if such strategic benefits were incorporated into the projections of future expected free cash flows, without specific evidence, the resulting conclusion of value would be a "hypothetical" answer, as required under professional standards. This hypothetical conclusion of value is intended to inform users of business valuations that there are hypothetical assumptions as to balance sheet composition and the income statement which affect future expected free cash flows and that differ from those that would be expected had the company maintained its same operating model at the date of valuation.

Though these concepts are clear within the confines of the business valuation profession, controversy exists with respect to these terms. As such, the authors recommend expanding traditional definitions to add language to ensure later understanding of the terminology as it was intended at inception of the document.

The opposing premise of value to "going concern" value is "liquidation value." Such a premise assumes that the company's assets (net of liabilities) are worth more under the selected standard of value than the ongoing operational value of its future expected free cash flows. Under this premise, it is assumed that the assets could be liquidated, the liabilities settled and the net liquidation proceeds could be distributed to the equity owner(s).

The underlying assumption is that the equity owner interest is not worth less than what the net assets could be sold for in the marketplace.

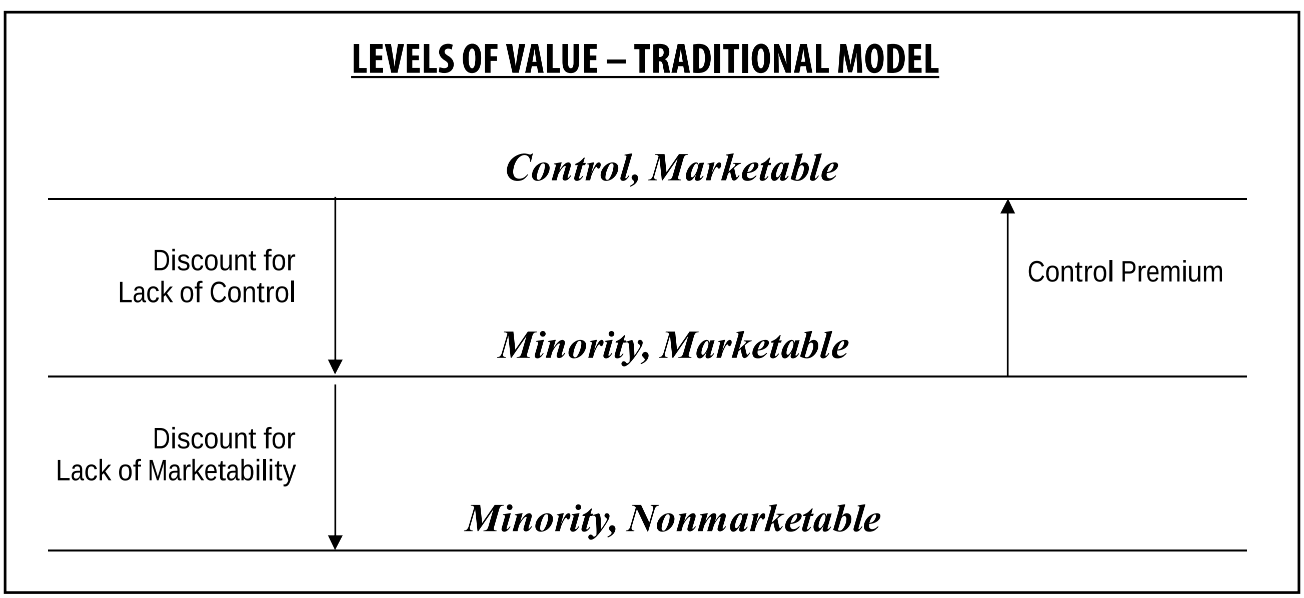
The liquidation premise of value can be further delineated between liquidation on an orderly basis and liquidation on a forced basis. The forced liquidation premise generally results in a lower amount of liquidation proceeds as assets are generally deemed to be sold in a "fire sale" circumstance.

Levels of Value

In conjunction with the determination of value using a fair market value standard, it is critical that the business valuator determine the propriety of any necessary premiums and discounts. At the heart of this determination is the development of an understanding of levels of value. Such levels are generally defined by the specific characteristics of control and marketability attributable to the subject equity owner interest.

From an investment risk perspective, owning an equity interest that allows the holder all perquisites of control over entity operations is clearly more valuable than an identical interest that does not allow for investor control. Similarly, the attribute of marketability adds value by lowering risk (due to the flexibility afforded by the presence of an available market for the equity interest), while the lack of marketability does just the opposite.

To compensate for the differences in these subject equity ownership interest characteristics, the business valuation profession has separated the investment characteristics into various layers, or levels, of risk assessment. Traditionally, the business valuation and finance communities have assumed three basic levels of value:



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In utilizing this "traditional" model, the critical presumption is that the type of value encompassed in the presentation is a financial value (the base for fair market value). In other words, the traditional model envisions the same measurement type with varying equity ownership interest characteristics. Note also that the mechanics of applying discounts in a multiplicative fashion (versus an additive fashion) results in the sum of the discounts for lack of control and lack of marketability producing an overall lower discount than simply adding the two raw numbers together.

An example illustrating this concept, assuming a 20% discount for lack of control and a 25% discount for lack of marketability, follows. Note, that while the two discounts in the example add up to a total of 45%. Proper application, nets the two discounts to 40%.

LEVELS OF VALUE – MULTIPLICATIVE APPLICATION OF DISCOUNTS

DISCOUNTS		VALUE
100%	*Control, Marketable*	$ 10.00
20%		(2.00)
80%	*Minority, Marketable*	$ 8.00
25%		(2.00)
60%	*Minority, Nonmarketable*	$ 6.00

It is now the position of most valuators in the profession that most market-observable control premiums include a synergistic or investment premium. Such thinking has led to an expansion of the traditional levels of value model, as illustrated on the following page.

The key aspect of interpreting the expanded model of levels of value is understanding that the three levels from the traditional model are based upon a financial value, whereas the fourth level included in the expanded model is based upon strategic or synergistic value. This fourth level cannot be properly considered in the determination of fair market value unless the synergistic premium is removed. Unfortunately, at the current time, empirical studies have not been sufficiently developed by which the strategic premium can be quantified.

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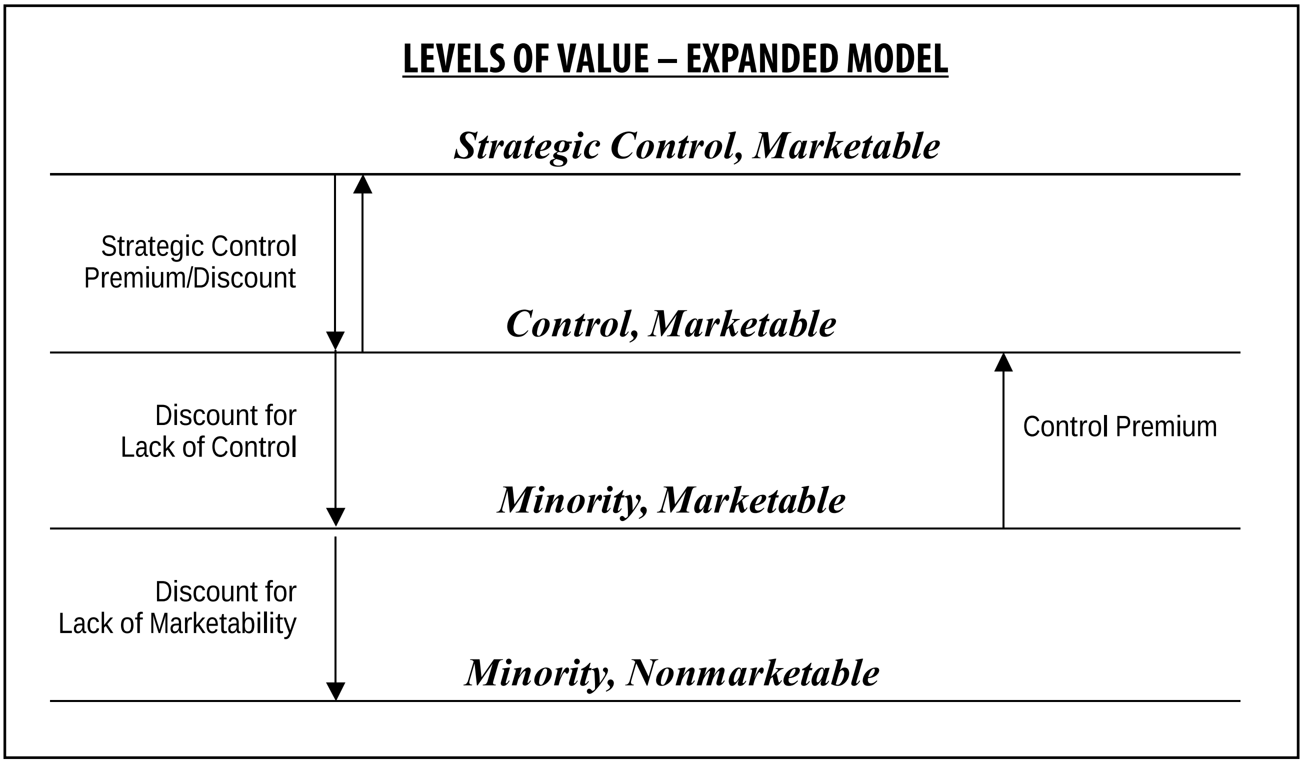

As can be discerned, numerous alternative levels of value models have been proposed by commentators. Most of these have very defined and sophisticated variations that remain highly theoretical and of little practical use in day-to-day application.

It is critical that all potential users of the business valuation report fully understand the different levels of value when drafting the buy/sell agreement. As has been discussed, flexibility is possible by virtue of carefully crafted modifications to standard language. However, once again, care must be exercised to ensure that the result is that which was desired and expected.

The Valuation Date

Valuation is a "point in time" determination. The valuation date is often referred to as the "as of date" of the business valuation. Generally, the date of valuation is set by language in the buy/sell agreement and is generally set by the occurrence of a trigger event. The date of valuation is an important element of the valuation because a company's business value can change materially over time. These changes in business value can result from factors that are either specific influences to the company (i.e., changes in current operating results), or external influences on the company (i.e., changes in the industry competition).

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The various dates of valuation often include:

- ***The date of notification*** – If the buy/sell agreement includes a "put" provision or a provision requiring a formal notification of the equity owner's desire to depart and sell his or her equity ownership interest, the date that the put is exercised or the date of the formal notice can serve as the date of valuation.

- ***The date of equity owner departure*** – The actual date of the equity owner departure is somewhat common to buy/sell agreements, but can present mechanical issues if that date is after the negotiation of the final purchase price for that interest. Generally, the final negotiations are completed after the valuation or appraisal has been rendered and subject to only all information "known or knowable" at the date of valuation. If such date is selected, it is not unusual that a business valuation is completed at an earlier date and brought forward to the date of the equity owner's departure.

- ***The date of transaction closing*** – The date of closing is also common to buy/sell agreements, but use of this date presents the same type of mechanical issues noted above when using date of equity owner departure. If such date is selected, it is not unusual that a business valuation is completed at an earlier date and brought forward to the date of the equity owner's transaction closing.

- ***The last quarter or year end*** – It is common to refer to the date of valuation as the last completed quarter or fiscal year end. The purpose in doing so is generally the availability of better and more complete financial information. While this date of valuation adds efficiency to the business valuation process, it is critical to include language that allows for adjustment for any material changes between that date and the estimated transaction closing date.

- ***The date of any specific trigger event*** – Setting the date of valuation to correspond to the date of a specific trigger event is yet another reasonable and logical means to establishing an appropriate measurement point in time. In these instances, a trigger event is generally "the date" and though transaction closing may be after the date of valuation, it is not unusual to transact at the trigger date without bringing the value forward to the date of closing.

Note that whatever date is selected for the date of valuation in the buy/sell agreement, language can be added to bring the value close to the date of closing which economically presents the most logical date. Consideration of material changes in operating and financial activities between the date of valuation and the closing date must be provided for in the agreement's language.

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Business Valuation Protocol and Process

The buy/sell agreement must include a protocol or process by which the value of the departing equity owner's interest will be determined. This critical consideration is often given too little focus and left for the parties to "create" at the later date when one or more equity owners decides to depart. Such an omission is unfortunate as the agreement itself should provide for the protocol or process so that the protocol or process, itself, does not become an issue of controversy. All too often, the authors have observed this outcome to be the case.

At the heart of any equity owner departure and the purchase/sale of his or her interest is the question of value. The means by which this value is to be determined varies widely and includes the following options.

"Pre-Set" or "Fixed" Value

Many agreements reviewed by the authors have a pre-set value that was agreed upon by all of the parties to the agreement. Occasionally, the value is set for the entire equity of the company or, alternatively, its invested capital (enterprise value). More often, the agreements reviewed by the authors have the value per share pre-set.

The important consideration in adopting a pre-set or fixed value lies within the means by which that number was determined. Rarely are such numbers simply picked out of the air. Such determinations are generally based on some underlying economic data and financial information. Assessment should be made in these circumstances as to the veracity of the pre-set or fixed value by properly analyzing the data and financial information on which that value is based.

It is important to recognize that all value is forward-looking. Thus, in making any analytical judgments of the underpinnings of the pre-set or fixed value, historical information is only meaningful to the extent that the trends and performance of the past is indicative of the company's future performance.

A second important consideration is the need to periodically update the number to incorporate changes due to business growth and other changes in the conduct of the active business of the subject company. A failure to ascribe an agreed-upon value each year or more often, if deemed necessary, can lead to a less than useful agreement when the time comes for its guidance.

Formulaic Determination of Value

Formulas seem to be somewhat popular methods by which to produce a conclusion of value in buy/sell agreements. As with a pre-set or fixed value, the driving necessity in evaluating the credibility of any formula approach rests with carefully analyzing the underlying assumptions and the construct of the formula.

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No formula can adequately incorporate all facets of a business valuation process undertaken in consideration of professional standards. However, as an expediency, a formula based on an actual valuation completed in accordance with professional standards may suffice during interim periods between periodic full business valuations. However, major changes in operations or company activities may require consideration and adjustment in the formula, or its conclusions.

No Process of Any Kind

The worst position is a buy/sell agreement that fails to address the valuation protocol or process in any manner. Such lack of guidance will most certainly lead to controversy at the date that a valuation is called for under the terms of the agreement. While it is rare to have no language addressing valuation protocol or process, such agreements do exist.

A Full Business Valuation

A full business valuation prepared by an accredited business valuator and undertaken in accordance with professional standards is clearly the best means by which to set a value that is defendable, appropriate and fair to all parties to the agreement. The preparation of a full business valuation can be undertaken at each year end to determine the value if the parties agree that such information is helpful. Alternatively, a full business valuation can be undertaken at the date of any trigger event or a date chosen by the parties when a trigger event occurs.

If engaging an accredited business valuator, defining the entire business valuation process is not necessary. The protocol or process for a full business valuation is encompassed in any accredited practitioner's compliance with professional standards. Thus, it is critical to ensure that language requiring business valuator compliance with professional standards is included in the agreement.

It is also noteworthy that an accredited business valuator can accept a calculation engagement, which is a service well below the level of a full business valuation. While the protocol and procedures used in a calculation assignment are agreed by the parties and the business valuation professional, they are generally not intended to supplant a full business valuation. The differences between a full business valuation and a calculation assignment are more fully addressed below under scope of the engagement.

An issue that must be addressed in consideration of obtaining a full business valuation is whether the parties will select a single business valuation analyst who will work for all parties, or whether each party will engage their own business valuation analyst. In any case, the buy/sell agreement should properly address the term "business valuator" to include an accredited appraiser and that any such professional engaged by either party must complete the process in accordance with professional business valuation standards.

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It is also necessary to include within the agreement a protocol or process to resolve differences in the conclusions of value reached by the separate business valuation analysts. If the protocol or process is to engage a third business valuation analyst, the process by which this selection is to be made should be carefully spelled out in the agreement as well.

The authors also believe it useful to include within the protocol or process set forth in the buy/sell agreement a provision that allows for a "cooling down period" after the exchange of conclusions of value and a meeting among the business valuation analysts to determine if the differences can be resolved and bridged.

It may also be helpful to provide within the buy/sell agreement a timeline for completion of the protocol. While undertaking a full business valuation is a complex and time-consuming process, it is possible to provide some limited parameters on timing to help prevent that process from taking an extended period to resolve.

Finally, it is always helpful to address which parties are responsible for professional fees in such assignments. Generally, initial fees appear to be paid by the company most often. Separate business valuation analysts, however, appear to be paid by both parties. The fees for a third appraiser are generally split between the affected parties.

Appraiser Qualifications and Professional Standards of Valuation Practice

As noted above, it is important to be knowledgeable of the specialized skills necessary for an appraiser to complete specific engagements. It is important to remember that merely being designated as a business appraiser on one's business card does not necessarily qualify one as an expert in the field. Experts are distinguished by their credentials, skills, experience and training.

Different appraiser qualifications have different governing bodies, and each has its own set of professional standards of appraisal practice for member appraisers to follow. These standards determine the steps and procedures a professional must use during the engagement. Identifying specifically which qualifications the appraiser must have when the buy/sell agreement is drafted can help prevent disagreements in later years during the appraiser selection process. The following summarizes the major credentials in the business valuation field:

American Institute of Certified Public Accountants (AICPA)

The American Institute of Certified Public Accountants is the national membership organization of certified public accountants (CPAs) in the United States. It is noteworthy that a CPA credential is not necessary for membership, nor is membership required for certified public accountants.

The AICPA sets various rules, professional standards and guidelines for its members. However, the AICPA does not oversee the uniform certified public accounting examination or issue the CPA credential. Both of

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these activities come under the auspice of each state's Board of Accountancy. Even if a CPA chooses not to join the AICPA, he or she may still be subject to the AICPA rules, as many state Boards of Accountancy adopt the AICPA rules (especially those relevant to professional conduct) in lieu of issuing separate rules.

The AICPA does issue a business valuation credential – **Accredited in Business Valuation (ABV)**. Only CPAs can obtain this credential, and the proper display of this credential is CPA/ABV. The ABV credential is business-valuation specific and, as noted, first requires a CPA license and membership in the AICPA. To obtain this credential, the CPA must pass a written examination and provide proof of experience by demonstrating "significant" involvement in at least six business valuation assignments or, alternatively, provide evidence of 150 hours that demonstrate substantial experience and competence.

National Association of Certified Valuators and Analysts (NACVA)

The **Certified Valuation Analyst (CVA)** credential is awarded to NACVA members who are CPAs and have completed a five-day training program, passed written examination and completed a rigorous business valuation case study. Additionally three personal and three business references are needed.

The **Accredited in Business Appraisal Review (ABAR)** credential is designed for business valuators whose work involves the review of valuation reports and analysis performed by others. A candidate for the ABAR designation must be a NACVA member who meets the education requirements and has a professional valuation designation awarded by a recognized professional association. To earn the credential, a professional must submit four references, complete a five-day course, pass an examination and prepare and successfully complete one business appraisal review report.

Earning the **Master Analyst in Financial Forensics (MAFF)** credential requires consideration of all of a professional's qualifications and commitment to the discipline. To earn the MAFF credential, candidates must attest to having met prerequisites and experience requirements and pass an exam focusing on financial forensics.

American Society of Appraisers (ASA)

The first ASA credential is the **Accredited Member (AM)** designation. An individual striving to become an AM must have a college degree and two years of full-time business appraisal experience. He or she must also complete four courses (three days each) with the successful completion of one half-day exam following each of the four courses or the successful completion of one all-day challenge exam. Additionally, an applicant must submit two appraisal reports to a Board of Examiners for review as evidence of professional capability.

The next, higher designation is the **Accredited Senior Appraiser (ASA)**. This designation is earned by meeting all of the AM requirements, plus an additional three years of full-time or full-time-equivalent experience.

Institute of Business Appraisers (IBA)

The Institute of Business Appraisers offers two different certifications relative to business valuation. The **Certified Business Appraiser (CBA)** designation is earned by an individual who is an IBA member and has met the requirements for education and business valuation experience. Candidates must complete certification training and an appraisal workshop, pass a five-hour written examination and submit two business appraisal reports to demonstrate a professional level of competence.

An individual who meets the above requirements, has a post-graduate degree, has held the CBA designation for at least 10 years, and has 15 years of experience can earn the **Master Certified Business Appraiser (MCBA)** credential. Three professional references are also required. The MCBA credential is the highest professional designation awarded in the business valuation industry and recognizes the extraordinary competence of a few highly skilled and experienced individuals.

Scope of the Engagement

It goes without saying that any accredited business valuator will employ a letter of engagement to define the scope of the project. Clearly, that scope should follow the protocol and process set forth in the buy/sell agreement. Professional standards promulgated by the practitioner's accrediting organization will govern the specific procedures selected by the business valuation analyst. The scope should be clearly defined so that all parties involved have the same understanding of the engagement, whether that be a full-scope business valuation or a calculation engagement.

Valuators must be knowledgeable of any government regulations and other professional standards applicable to the engagement, and the extent to which they apply to engagements to estimate value. Compliance is the responsibility of the appraiser. With this said, there are two types of engagements to estimate value including a valuation engagement and a calculation engagement. In the simplest terms, and as addressed earlier, a calculation engagement does not include all of the procedures required in a valuation engagement.

The type of engagement is established in the understanding with the client and end-user of the work product. This should be done at the outset of each engagement. The following is a summary of the differences between a valuation and a calculation engagement, pursuant to professional standards.

An appraiser performs a ***valuation engagement*** when the project calls for the valuator to estimate or opine on the value of the subject interest. The appraiser can apply the valuation approaches and methods he or she deems appropriate in the circumstances. Procedures applied should be in compliance with all applicable valuation standards. The appraiser expresses the results as a conclusion of value – either a single amount or a range.

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In performing a valuation engagement the appraiser should:

- Fully understand and analyze the subject interest;
- Consider and apply appropriate valuation approaches and methods; and
- Prepare and maintain appropriate documentation.

Valuations involve an ongoing process of gathering, updating and analyzing information. There are numerous detailed procedures that are performed by the valuator in connection with each of the above.

The purpose of a ***calculation engagement*** is to estimate value (versus opining on value), wherein the appraiser and the client agree on the specific valuation approaches and methods that the appraiser will employ and the extent of the valuation procedures that he or she will perform to estimate the value of the subject interest. Therefore, the appraiser is not free to apply any and all approaches and methods he or she deems appropriate. The appraiser expresses the results of the calculation engagement as a calculated value, which may be either a single amount or a range.

In performing a calculation engagement the appraiser should consider the following:

- Identity of the client and the subject interest
- Purpose and intended use of the calculated value
- Intended users of the report and limitations on its use
- Effective date of the calculation
- Applicable premise of value and standard of value
- Whether or not the business interest has ownership control and its degree of marketability
- Sources of information used in the calculation
- Valuation approaches and methods agreed upon with the client
- Subsequent events, if applicable

The calculation report should note that the engagement does not constitute a full valuation as applicable standards define, and had a valuation been undertaken, the results might have been different. Appendices or exhibits may be used by the appraiser for required information or information that supplements the calculation report. The appraiser's assumptions and the limiting conditions should also be detailed in the calculation report.

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Hypothetical conditions affecting the subject interest may be required in some instances. When hypothetical conditions are employed during a valuation or calculation engagement, the appraiser should indicate the purpose for including such conditions and disclose these conditions in the report.

There have been instances in practice where a calculation is performed for a client and, subsequently, the need arises for a full valuation. Consideration of the information and methods employed in the calculation engagement can be used to efficiently transition to a full valuation.

There are many factors that must be considered in the determination of whether a particular circumstance can call for a calculated value versus an opinion of value. All parties involved in the process should have an understanding of the differences between the two types of engagements and the procedures undertaken prior to commencing the project. Moreover, understanding the difference between a full business valuation and a calculation of value should be important to those drafting buy/sell agreements, as the scope should be clearly defined within the agreement.

In Conclusion

No amount of language in any contract, including buy/sell agreements, can guarantee to address every aspect of potential controversy. However, addressing the many valuation matters that can arise in such contexts as carefully as possible at inception can go a long way in preventing and mitigating the many potential challenges that could arise when the time comes to invoke the guidance of the agreement.

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V. Case Law Examples of Problem Areas in Buy/Sell Agreements

In the Introduction to today's program, we presented you with the Arizona Tea case, which is just one example of the many cases fueled by non-existent or unclear buy/sell agreements. The following section presents a few additional examples where certain key provisions (or lack thereof) in a buy/sell agreement led to a level of uncertainty on the part of one or both parties sufficient to bring the matter to litigation. Unfortunately, such results are all too common and reflect the outcomes associated with ineffective buy/sell agreements.

Note that the case law presented here is NOT intended to be a compendium of all relevant cases on the topic. Rather, it is intended to provide some insight into challenges to such agreements and how the courts have interpreted the failures of some less-than-adequate agreements. The authors recommend that participants in today's program always undertake their own legal research to ensure adequacy of that process.

In reviewing these cases, note that the courts will generally follow the valuation processes and mechanisms set forth in any applicable operating agreement, including buy/sell agreements. Typically, a court will follow the valuation mechanism depicted in the subject operating agreement in the event that the particular situation is addressed. The following 2006 court cases emphasized that the courts will often look to a buy/sell agreement's definition of value to help settle a dispute.

Definitions and Terminology Matters

Estate of Maurice F. Frink, No. 6-433 (Iowa App. October 25, 2006)

- This dispute concerns a 1974 amendment to the corporate by-laws of Flowerama of America, Inc. ("Flowerama") that restricted the transfer of corporate stock upon the death of a shareholder.
- Maurice F. Frink was the majority shareholder of Flowerama when he died in 2004.
- Maurice and his brother, Herbert, co-founded Flowerama in 1966. The articles of incorporation, signed on April 21, 1966, restricted the transfer of corporate stock.
- On May 10, 1966, Maurice and Herbert signed a stock purchase agreement as the sole shareholders for the stated purpose of "provid[ing] for the purchase by the Corporation of the decedent stockholders' stock interest therein." The stated value per share was $100.
- On October 4, 1974, the May 10, 1966 stock purchase agreement was rescinded in a revocation document signed by all shareholders (by 1974, the corporation had five shareholders.)

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- On October 7, 1974, the articles of incorporation were amended to include the following language:
  - "The corporation shall have the power to restrict the transfer of shares of common stock by provision in its by-laws. Any such restriction shall be printed on each certificate of common stock."
- Also on October 7, 1974, the shareholders and directors signed an information action amending the by-laws to restrict the transfer of stock as follows:
  - "…in the event of the death of shareholder, the corporation, upon demand made on the legal representative of the deceased shareholder, shall have the right and first option within five months of the last day of publication of notice of the appointment of the legal representative to purchase all of the shares of stock owned by the deceased shareholder as of the date of his death…The purchase price for such stock shall be the book value as of the date of death as determined by the accountant who regularly prepares the Balance Sheets and Profit and Loss Statements for the corporation."
- In 1986, one of the shareholders died. The corporation, pursuant to the 1974 Agreement, purchased his stock from his estate for the book value price per share. Similarly, following the 1988 death of another shareholder, the corporation repurchased his stock from his estate for the book value price.
- At the time of his death on June 1, 2004, Maurice was the majority shareholder in the corporation. The corporation, acting through its directors and officers, resolved to repurchase Maurice's shares from his estate pursuant to the 1974 agreement. The corporation further resolved "the purchase price will be the book value per share as of May 31, 2004."
- The corporation's accountant, who was also a shareholder and board member, determined the book value of Maurice's shares was $896,403.85. Independent auditors confirmed this calculation of the book value.
- The corporation offered to tender the book value to Maurice's estate in exchange for the shares. The executor of his estate refused the offer, and litigation ensued.
- The beneficiaries claimed that the term "book value" in the agreement actually meant "fair market value."
- The court found that dictionaries consistently noted the difference between the two values.
- The court also noted that the company had consistently utilized "book value," as defined under generally accepted accounting principles (GAAP), when it made redemptions in the past. The court enforced the buy/sell agreement.

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Etienne v. Miller, No. F049110 (Cal. App. 5 Dist. October 23, 2006)

- The matter before the court in this case was whether a buy/sell agreement between two brothers should be enforced against a trust holding the brothers' businesses and business interests.
- The trust documents directly mentioned the obligations under the buy/sell agreement.
- The beneficiaries argued that the enforcement of the agreements would create a significant federal estate tax burden because it provided for lower-than-market value prices.
- The court found that the trustee should enforce the agreements, as non-enforcement would negate the purpose of the trust

There are pros and cons with respect to using a formulaic valuation provision, such as book value, in a buy/sell agreement. Some of the advantages are that formulas are relatively straightforward, easy to understand and less expensive as there may be less involvement of outside professionals. The main drawbacks are that goodwill is excluded from the calculation, the potential that the company's accounting method includes unpaid liabilities and the possibility that the parties' situations may have changed since the buy/sell agreement was initially signed. Further, these formulas lack consideration of subjective information that valuators are required to consider, some of which could have significant impact on the value. Such subjective information may include the company's risk premium, future growth expectations, current economic conditions, the industry outlook, and/or other key factors that involve professional judgement and analysis.

Additionally, consideration should be given to the withdrawal of a member, partner or shareholder dissension, as any of these situations could be a triggering event for a buy/sell agreement. The following cases involve shareholders who dissented over the formulaic valuation provision in the governing agreement.

Tynes E. Mixon, III, M.D. v. Iberia Surgical, LLC, No. 06-878 (La. App. 3 Cir. April 18, 2007)

- Iberia Surgical was formed in August 1998 by a group of physicians practicing in Iberia Parish (Louisiana) for the purpose of establishing an ambulatory, out-patient surgery center.
- Each of the 11 physician members contributed $5,000 and obtained a 9.09% interest in the business. Dr. Mixon was one of the original organizers and became the managing partner.
- The members executed a written Operating Agreement, which provided that a member may be terminated "without cause" upon unanimous vote of the membership.

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- The contract also contained a "Buy-Out" provision in case of termination or withdrawal by one of the members. The agreement stated:
  - The purchase price of a former member's interest which is sold as a result of the occurrence of a dissolution event, shall be determined as follows:

    …the "book value" means the "fair market value" of a membership interest computed in accordance with generally accepted accounting principles, of the net equity of the Company as of the end of the last full taxable year immediately preceding the year in which the event giving rise to the purchase and sale of the membership rights or interest occurred. Notwithstanding anything contained in this agreement to the contrary, the computation of book value shall be subject to the following provisions. …Book value shall be determined by the accountants regularly employed by the Company. The determination of the accounts shall, for the purpose of this Agreement, be binding and conclusive upon all parties.

- In June 1999, Iberia Surgical, in a joint ownership venture with Iberia Medical Center, formed New Iberia Surgery Center, LLC, an outpatient surgical facility. Iberia Surgical owned an 80% interest, and Iberia Medical Center owned a 20% interest in the new facility. The New Iberia Surgery Center was managed by a professional management company, Genesee & Associates, Inc.
- Shortly after the formation of Iberia Surgical, Dr. Mixon became dissatisfied with the operation of the new facility and the management practices of his fellow physicians.
  - On several occasions, he voiced concerns regarding patient care and what he perceived to be violations of federal law in the handling of Medicaid patients.
  - While the members took no action regarding his complaints, Dr. Mixon met with federal authorities to report the alleged violations.
  - Dr. Mixon disclosed to several partners that he had reported them to federal authorities. He then began to fear he may be terminated from membership in Iberia Surgical by a vote of the organization.
- On August 28, 2002, Dr. Mixon was terminated from Iberia Surgical by unanimous membership vote.
  - Pursuant to the buy-out provisions of the operating agreement, the accountant computed a book value of Mixon's interest at $71,357. Dr. Mixon was paid over a 12-month period for his interest.
- Mixon appealed and obtained his own CPA to value his interest.
  - His CPA used a 9.89 net income multiple to compute a $483,100 value.
  - The CPA argued that book value and fair market value are not the same.

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- The Court agreed that book and fair market value are not the same, but the parties signed an agreement defining fair market value as book value.
- The Court rejected Mixon's appeal and sided with the Company (and operating agreement) as Mixon never contended that the book value was improperly calculated.

Wood v. Wood, 361 S.W.3d 36 (Mo. Ct. App. 2011)

- Stephen Wood (husband) owned a 30% interest in a privately held flooring store. On February 6, 2009, Heidi Wood (wife) filed a petition for dissolution of marriage. At the divorce trial, both husband and wife presented expert testimony on the value of the husband's interest in the business.
- The wife's expert applied the valuation formula included in the company's buy/sell agreement that her husband and the two other shareholders entered into in 2007 when they purchased the business.
- The formula provided that the total shares' value equaled the last appraised value of the company, plus or minus earnings or losses, and less dividends paid or declared by the board.
- Using this approach, the wife's expert calculated the total value of the business to be approximately $3.5 million, with the value of the husband's interest at approximately $1 million.
- The husband's expert conducted an actual appraisal of the business and presented an opinion on the fair market value of his ownership interest.
  - The expert relied on traditional measures of valuing closely held businesses, including accounting for goodwill, minority ownership, and the impact of the economic recession.
  - Using this approach, the husband's expert calculated the total fair market value of the husband's interest to be $325,000.
- The trial court found the testimony of the wife's expert to be more persuasive and credible and, thus, relied upon her valuation formula's calculation. The husband appealed.
- The appeals court noted that in a divorce proceeding, the objective of a business valuation is to determine fair market value as of the date of trial. However, the wife's expert did not calculate fair market value. Furthermore, he did not use a current appraisal of the business as part of his calculation. Instead, he used the historical value of the entire business in 2007 when the shareholders bought the store as the starting point, rather than the fair market value on the date of divorce.

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- The appellate court acknowledged that a trial court generally can accept the opinion of one expert on value over another and can prefer one valuation method over others based upon the facts of the case. However, when an expert does not attempt to determine fair market value, a trial court cannot find it more persuasive and credible than another valuation.
- Therefore, the appellate court concluded that the trial court had misapplied the law and reversed and remanded for a proper determination of the value of the business as of the date of the divorce.

Trigger Event Matters

The following case addresses the potential problems that can occur when a triggering event, such as a divorce, is not addressed explicitly in a buy/sell agreement.

In re the Marriage of Barnes, No. 2006AP3020-FT (Wis. App. May 17, 2007)

- Kent and Terry Barnes were married in 1975 and engaged in farming throughout most of their marriage. Terry eventually went back to school to obtain a teaching degree, while Kent sold the cows and opened a hardwood flooring business.
- In 1994, Kent entered into a limited liability farm partnership agreement with his parents, which Terry also signed as a spouse. The partnership agreement designated Kent as the general partner and his parents as limited partners.
- The partnership agreement specified how to value Kent's interest as general partner in the event that he were to die or withdraw from the partnership and one of his parents wished to purchase his interest. The agreement contained a separate provision specifying how to distribute the proceeds of liquidated partnership assets in the event that the partnership was dissolved. The partnership agreement did not provide a contingency for a partner's divorce.
- When the couple divorced, the parties submitted conflicting figures regarding the valuation of the farm, some cooperative stocks, some outstanding liabilities, and Kent's hardwood floor business.
- The trial court adopted Terry's proposed valuation of Kent's interest in the farm partnership using the formula that would apply if Kent were to withdraw from the partnership, and accepted her figures for the cooperative stocks, the outstanding debts, and the valuation of the hardwood floor business.

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- Kent appealed, arguing that it was improper to use the withdrawal valuation formula, because he was not withdrawing from the partnership. He argued instead, that the court should have used the liquidation valuation method that would apply if the partnership dissolved.
- The court found this argument flawed as even though there was no evidence that he was going to withdraw from the farm partnership, there was also no evidence that the partnership was going to be dissolved or liquidated, stating, "The partnership agreement quite simply did not make any provision for valuation in the event of a divorce."

<u>*Sullivan v. Troser Management, Inc.*, 2013 N.Y. App. Div. LEXIS 1641 (March 15, 2013)</u>

- In this matter, the lack of an effective valuation method in a shareholder buy/sell agreement led the parties to 10+ years (four rounds) of litigation. However, the appropriate valuation method remains undefined.
- Plaintiff served as Defendant's director of sales for the operation of a ski resort. In 1986, the parties made an agreement that promised Plaintiff an 18% equity interest in Defendant's closely held corporation if he remained employed until year-end 1991. Under a contemporaneous buy/sell agreement, Defendant had the option to buy back Plaintiff's stock if, among other things, the employment ended.
- The purchase price was to be "an amount agreed upon annually by the Stockholders as set forth on the attached Schedule A." If the parties failed to establish an annual value, "the value shall be the last agreed upon value except that if no such agreed upon value is established for period of two years, the value shall be the last agreed upon value increased or decreased by reference…the company's book value."
- The agreement listed Plaintiff as a "stockholder." However no Schedule A existed.
- In 2003, Plaintiff sued in state court for specific performance of the stock issuance.
- Plaintiff requested an order that, once the stock was issued, Defendant had an obligation to repurchase it and a determination of the parties' rights under the buy/sell agreement.
- The trial court directed Defendant to issue 18% of its shares of stock to Plaintiff, which the Defendant subsequently did. The court also ordered the parties to execute the buy/sell agreement and fixed a price for the purchase. Specifically, it valued the buy-back interest at an amount that aligned with a prior buy-out involving a different shareholder. Both sides appealed.
- In 2005, Defendant sought dismissal of the complaint, arguing it was time-barred. The appellate court declined. At the same time, it granted Plaintiff's request to overturn the lower court's attempt to set a purchase price for the shares.

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- In 2006, the trial court directed Defendant to repurchase the stock for approximately $110,000, based on Defendant's claim that the method to value the stock was by prorating the value of its parent corporation among that company's three subsidiaries.
- Plaintiff appealed, contending that the agreement required that the two stockholders of the Defendant determine the value of the stock, not the owners of the parent corporation. He also provided a letter he had received from Defendant's attorney in 1999 that specified a different valuation method.
- The appellate court ruled for Plaintiff.
- In 2009, the trial court denied Plaintiff's request for a determination that his shares "be valued on the basis of his percentage interest in the Defendant's assets" in the event that Defendant exercised its option to buy back the shares. He advocated for the use of a net asset approach that the state's highest court had approved in a case about the buy-out of a law firm partner pursuant to an agreement that provided for a future agreement among partners that never came into existence.
- Plaintiff appealed, contending the agreement's purchase price provision was unenforceable.
- Defendant presented other stock valuations.
- The appellate court said Plaintiff showed, "as a matter of law that the stockholders have never agreed upon a value of the stock." Accordingly, there was no way to ascertain his share price in accordance with the terms of the buy/sell agreement.
- Evidence of stock valuations from other transactions were of no consequence because Plaintiff was not a party to them.
- In 2011, the trial court denied Defendant's motion to set the stock purchase price at approximately $184,000 based on its expert's calculation. The expert had used the same formula Plaintiff proposed in 2009. The appellate court affirmed the denial.
- Its 2010 ruling notwithstanding, it stated it did not then require a net asset valuation, a method the high court approved but did not mandate. The court clarified that its earlier decision established that Plaintiff's shares had to be valued "on the basis of his percentage interest."
- However, issues of fact as to what the appropriate method for valuing Defendants' assets remained.
- The court rejected Defendant's claim that the buy/sell agreement's reference to book value dictated its use to determine the price for the plaintiff's shares. The parties never agreed on the value of the shares, and there was no adjustment to be made.

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- The appellate court stated there was "no uniform rule for valuing stock in closely held corporations." A court must tailor the valuation method to a particular case, based on the evidence at trial.
- The appellate court agreed with the Defendant that the trial court had erred in finding Defendant had exercised its option to buy back the shares. The appellate court concluded a resolution of this question could wait until the Defendant actually refused to buy the shares at the price the lower court set after a trial on the value of the shares.

Estate Planning Matters

There are several Tax Court cases that address the use of a buy/sell agreement for estate planning purposes. Examples of these cases include ***Estate of Lauder v. Commissioner*** (T.C. Memo 1994-527)**,** ***Estate of True v. Commissioner*** (T.C. Memo 2001-167), and ***Estate of Blount v. CIR*** (T.C. Memo 2004-116).

These cases work to establish the following:

- Buy/sell agreements can be critical for estate planning purposes. In some cases, the fair market value of the interest for federal estate tax purposes may be defined in the agreement.
- In order for this to be the case, a number of factors must be true:
  - The price must be fixed and determinable under the agreement;
  - The agreement must be binding in life and death;
  - The agreement must have a bona fide business purpose;
  - The agreement must not be a testamentary device; and
  - The agreement must be similar to those entered into at arm's length.

In Conclusion

As evidenced and confirmed in these court cases, buy/sell agreements are complex, and without careful attention to detail, can lead to great acrimony and litigation. There is simply no replacement for a serious focus on terminology, identification of applicable trigger events, rights of the parties and valuation in these agreements. Without such a focus, the provisions are unlikely to suffice at that date in the future when the operative provisions are most needed.

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VI. Concluding Thoughts and Practical Considerations

Upon incorporating the breadth of the information in this presentation, the question becomes, then, how can an advisor best aid an equity owner group in getting a workable and effective buy/sell agreement in place?

As noted throughout today's presentation, the critical element to move the process forward is to know your client and start as soon as possible. The real starting point for the advisor team is in joining resources to fully understand the equity owner group's key concerns and goals, not only from the perspective of handling transitional issues in the future as equity owners enter and exit the business, but also from a business perspective. This process requires an in-depth understanding of the means by which the equity ownership group came together and exactly what is expected by their pooling of capital resources into the active conduct of a trade or business. The authors view the understanding of the a client's business plan and goals as integral to the overall creation of a buy/sell agreement.

Development of such an understanding provides the advisor team with the information necessary to develop a baseline recommendation from which further modification can be made with additional research and discussion with the client. If necessary, the process can be repeated and further revised. Ultimately, through these ongoing modifications, the resultant specific provisions, language and content can be drafted to serve as the backbone of any final buy/sell agreement.

The initial recommendations will include a suggested structure for the agreement. Whether a cross-purchase, entity purchase or redemption, or some hybrid structure is recommended, the advantages and disadvantages associated with the structure should be carefully spelled out and reviewed with the equity ownership group. Understanding that misinterpretations of key client concerns and goals may occasionally lead to a need to modify the recommendations, the process provides room for such an evolution.

Implicit in the development of the baseline recommendations for an overall structure for the agreement is the need to carefully consider and recommend the three major items of note in any quality buy/sell agreement:

- Determine and define specific trigger events that will cause the agreement to become operative,
- Determine and define the valuation-related terminology at which the valuation of the business, and the selling equity-owner's interest will be governed by when a trigger event occurs, and
- Determine and define the means by which the repurchase of any selling equity owner's interest in the business will be funded.

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The information specific to the crafting of a final buy/sell agreement will be gathered through this type of process. With input from all members of the advisor team, the final provisions of the buy/sell agreement will be addressed and proposed to the client. Once the document is reviewed to ensure all of the equity ownership group's key needs, concerns and goals are met, the document can be finalized and executed. It is not unusual that this process may take multiple rounds of discussion, not only within the advisor group, but also with the equity ownership group to get the most meaningful and useful agreement possible.

One should not be susceptible to the assumption that equity group execution of the final buy/sell agreement ends the process. In fact, the use of the word "final" is really a fiction, as the best buy/sell agreements are most often those that are subjected to periodic review and modification, if necessary. Such periodic reviews can enhance the effectiveness of any legal document, and this is especially true in the realm of buy/sell agreements.

For companies and equity owner groups that are in the organizational stages of starting a new enterprise, there is no better time to develop and adopt a buy/sell agreement. As noted in Chapter I, the earliest stages of an entity's lifecycle are when all equity owners are most in tune with the goals and objectives of the company, as well as each other. The authors have found that in such early-stage discussions, most equity owners are amenable to reasonable provisions within the buy/sell agreement.

For companies and equity owner groups operating established businesses that do not have a buy/sell agreement in place or whose buy/sell agreement is outdated, the possibility of implementing a buy/sell agreement that is well received by all is unlikely. It does not seem to take long for disparate goals and objectives to arise among the parties and to fractionalize the unity that was present at the forefront of the business. However, the importance of adopting, or updating, the buy/sell agreement at these later stages in the business's existence cannot be overstated, as a failure to do so will lead to compound problems at that date in the future when the operative provisions of the agreement will need to provide guidance.

In both instances, clarity of explanation and a full understanding of the implications and impacts by all parties of each provision within the agreement is paramount to gaining acceptance and consensus. For the betterment and well-being of the business, this understanding can generally be turned into an executed agreement that better serves the equity ownership group.

Also, it should be emphasized that buy/sell agreements, and especially the operative provisions within those agreements that address questions of value, can lead to broad interpretations of value for other purposes. As noted in Chapter III, the Internal Revenue Service may look to these provisions so long as the agreement is found to be bona fide and reflects arm's length principles.

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Another place where the authors have observed buy/sell agreements coming into play is litigation, especially marital litigation. Setting the value anywhere can have an impact on these "non-equity owner" determinations and transactions, even though the agreements are generally drafted with no consideration of these other uses. However, while the terms of a buy/sell agreement are not determinative in such unrelated applications, the triers of fact do look to these documents as one indication of value in making their rulings and decisions.

One important consideration in the buy-out of an equity owner is additional "premiums" paid to the selling equity owner by the remaining equity owners in a cross-purchase arrangement of the company in an equity purchase or redemption arrangement. Very often, disputes, particularly those arising in the context of valuation, require some negotiation between the parties. As a result of these negotiations, it is not uncommon for the selling equity owner to receive an increase in purchase price consideration over the amount determined in conjunction with the valuation provisions within the agreement.

In these instances, the additional consideration may not actually be a reflection of fair market value (if that is the standard of value selected.) The additional consideration may be nothing more than a type of "nuisance" or "settlement" payment to the selling equity owner to get the deal done and persuade the selling equity owner to accept the consideration. The authors often find this distinction to be critically important and believe it is always best to bifurcate the consideration into portions applicable to the fair market value determination and the premium paid for settlement and risk of litigation, etc. In this way, should the transaction later be reviewed for any reason (a requirement under professional business valuation practice standards), the determination of value can be clearly carved from total consideration paid for the selling equity owner's interest.

The very essence of a strong and effective buy/sell agreement is the prevention or minimization of business disruption at the date of the trigger event and the preservation of the interests of the remaining equity owners and the business going forward. Developing an agreement meeting these criteria is certain to be a worthwhile endeavor on the part of the equity owner group, the business and the advisor team.

Grossman Yanak & Ford LLP has played a number of critical roles in the area of buy/sell agreements, and we have partnered with members of the legal community in many of these capacities. Some examples of these assignments include:

- Joining in meetings with legal counsel and other advisors, generally insurance professionals and accountants to assist with the exploratory stages of developing a buy/sell agreement
- Joining legal counsel and other professionals in meeting with equity ownership groups to explain the need for quality buy/sell agreements and to assist those equity owners with understanding certain elements of buy/sell agreements

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- Assisting with the drafting of provisions within buy/sell agreements that affect the matter of valuation
  - We have spent a great deal of time with attorneys explaining, advising and offering recommendations related to commonly accepted terminology and helping to customize that language to accommodate the intentions of the equity ownership groups, in addition to helping to develop language for the business valuation protocol and process
- Assisting with the periodic review of "in place" buy/sell agreements and critiquing the language within the agreement affecting the determination of value
- Providing assessments of buy/sell agreement language in matters of controversy
- Providing business valuation services in conjunction with the language provided in a buy/sell agreement
- Providing review, analysis and assessment of an opposing expert's determination of value as the work complies with the mandates of the buy/sell agreement
- Providing review, analysis and assessment of an opposing expert's determination of value as the work complies with the required professional business valuation standards of practice
- Providing general litigation assistance with respect to preparation for a deposition, hearing, trial and/or negotiation
- Providing third-party resolution services in accordance with the business valuation conflict provisions of a buy/sell agreement

We would be very happy to discuss your matter at any time and to assist you in any of these areas, as well as with any other economic matters resulting from your case. To that end, please feel free to contact us to discuss how we might be able to help your matter move forward.

As noted earlier, it is not possible to fully explore every nuance and implication of buy/sell agreements in a presentation of this length. However, we hope that the information conveyed in this continuing legal education session was helpful, and that the time taken from your busy schedules today has proven worthwhile.

Should you find that you have a specific question or an interest in speaking to one of today's presenters on the topic of buy/sell agreements, please feel free to contact any of them at your convenience.

The professionals at Grossman Yanak & Ford LLP, and especially the authors, appreciate your kindness in attending today's session and we hope to see you at a future program. Thank you!