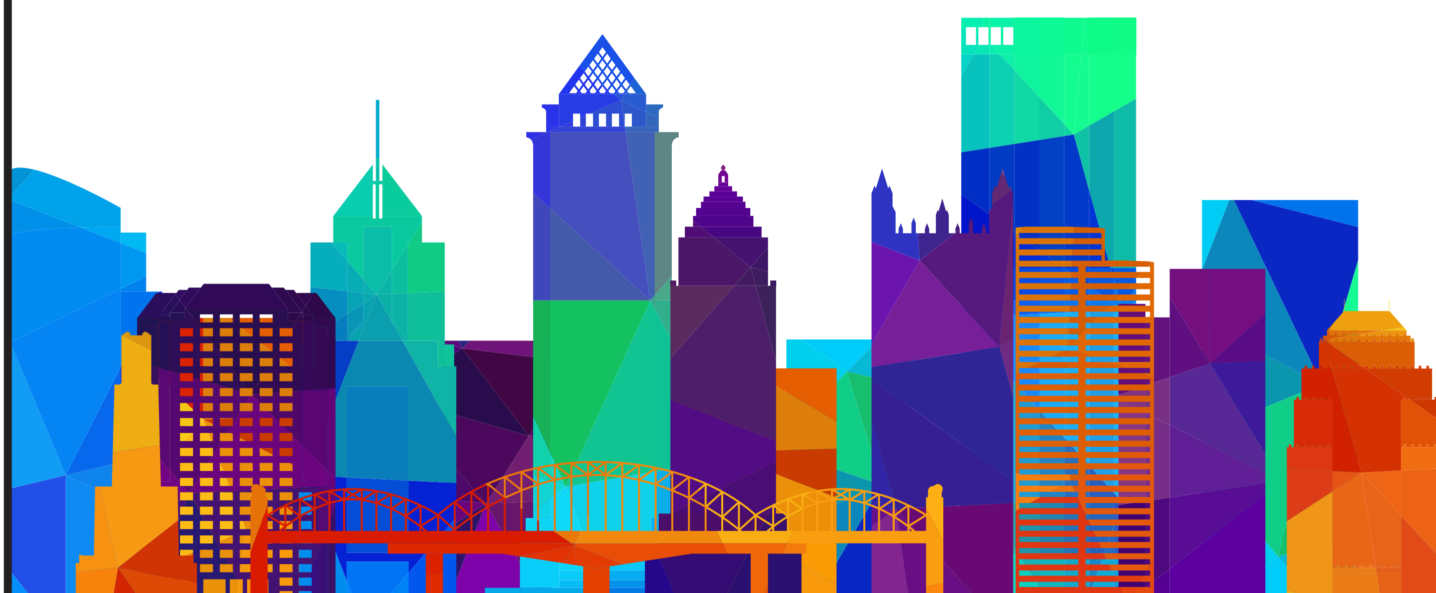
Special Purpose Valuations

Understanding The Nuances of:

Valuations for Transaction Planning
Estate and Gift Planning Valuations
Valuations for Litigation Purposes
Employee Stock Ownership Plan Valuations
Accounting-Based Valuations

GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants



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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 70 personnel who serve corporate and not-for-profit entities.

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

Bob heads our firm's Tax and Business Valuation Groups. He has nearly 40 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 nearly 25 years. She has significant experience addressing 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 credential of Certified Valuation Analyst, conferred by the National Association of Certified Valuators and Analysts (NACVA).

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 NACVA's Executive Advisory Board. 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/ABV, 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. He 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.

Logan W. Nawrocki

Logan has one year of experience as a financial analyst, in addition to over a year working in the valuation industry. His involvement as part of the GYF Business Valuation team includes performing risk identification, financial statement analysis, industry and economic research, and financial modeling.

Logan has assisted with the valuation of privately-held companies for estate planning, shareholder buyouts, employee stock ownership plans, and general corporate planning purposes. He is also is heavily involved in the provision of litigation support services.

Logan earned his B.S. in accounting from Saint Vincent College in 2018, graduating cum laude, with a minor in operational excellence. He has previously served Grossman Yanak & Ford LLP as an intern on the firm's Audit & Assurance team. Additionally, Logan worked as an analyst in the healthcare industry.

Logan is the Treasurer on the board of a local Pittsburgh non-profit and is a member of the Pennsylvania Institute of Certified Public Accountants (PICPA). In his spare time, he likes to relax with his dog, London.

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Special Purpose Valuations

I. Introduction

No element of finance can be more perplexing than the idea of value. This is especially true in the context of understanding value as it applies to a privately held business or an ownership interest in that business. Though a common topic of discussion among such businesses' ownership groups, it is also true that value is often misunderstood. The primary driver of these misunderstandings is that value will vary based on the expected use or purpose of any value determination.

Purpose is the topic of today's presentation. The authors have observed over many years value determinations undertaken for a wide variety of expected uses and purposes. While the purpose is generally understood to those who would initially engage a business valuation specialist, what is very often unknown is the dynamic as to how a particular purpose invokes consideration of alternative procedures and protocols within the application of generally accepted business valuation principles. In addition, governing professional standards promulgated by the professional credentialing organizations (including the American Institute of Certified Public Accountants, the American Society of Appraisers and the National Association of Certified Valuators and Analysts) mandate adherence and compliance with standards that dictate procedural considerations predicated on purpose and/or expected use of the final value determination.

First, it must be understood that a proper determination of value can provide the answer or solution to any number of operational, transactional or legal issues. Neither generally accepted business valuation principles nor professional standards limit the uses of a business valuation, and those uses can be as expansive and dynamic as the creativity and analytical analysis of any company's management group.

To be sure, there are very common expected uses and purposes for most business valuations. The most prominent of those, in the experience of the authors, will be discussed in this program. An example of the purposes for which we are most often engaged include:

- ***Transaction Planning*** – In transaction planning, value determinations are generally used as a baseline in estimating value for purposes of assessing enterprise value for the entire company, in contemplation of an actual sale or other disposition of that business or a shareholder or equity owner admission or exit, including both voluntary and involuntary transactions.

  Valuation in transaction planning often includes consideration of income tax implications associated with the purchase or sale of a business. Such implications often include allocations of the purchase price among asset classes and are critically important in promoting tax structures in negotiation that can effectively promote the position of the client.

Special Purpose Valuations

Also included in transaction planning are the concepts of accounting-based purchase price allocations and of transaction fairness from a financial point of view and fairness opinions of a contemplated transaction are a regular, and prudent, occurrence. These elements are most often associated with both accounting-based valuations and transactions, discussed below and later in these materials.

- ***Estate and Gift Tax Planning*** – The primary motivation behind completing business valuations for this purpose is to efficiently transfer a privately held business, especially one that is closely-held, to successor generations with focus on minimization of any federal or state transfer taxes. Over many decades, primarily dating back to the late 1950s, the Internal Revenue Service and the U.S. Courts have been the chief promoters of business valuation theory as it applies to this purpose. In no other aspect of business valuation has more information been published, and much of the guidance developed over the last 60 years has also been incorporated into general business valuation theory for other purposes.

  Interestingly, valuation in the context of estate and gift planning provides differing purposes dependent upon the federal and state estate and gift tax laws in effect at any particular date of valuation. For example, current federal estate tax rules allow for the transfer of nearly $11.6M per individual ($23.2M per married couple with gift splitting). As such, many privately held businesses are not subject to a federal estate tax on the transfer of that business to junior generations as the values do not exceed these thresholds. In these cases, it may not seem necessary to obtain a valuation for estate tax purposes for the senior-generation owner at his or her death, since no estate taxes will be due. However, the need for a valuation still exists to allow the junior-generation heirs a definitive assessment of value at the date that the equity interest in that business is inherited to allow for a well-documented "tax basis step-up", which will serve those individuals well in the future should the business later be sold.

  Lastly, in many situations relating to estate and gift tax planning, annual gifting serves as a means for facilitating an efficient succession plan. In these instances, annual valuations may be necessary to facilitate compliance with the gift tax filing requirements under the tax law and to remain within the annual exclusion amount of $15,000 per donor.

- ***Litigation*** – In many legal dispute matters, including shareholder oppression, shareholder buyouts and marital dissolution, resolution turns on valuation. Not only do generally accepted business valuation principles and professional standards impact valuations undertaken for these purposes, but jurisdictional venues also play an important role in dictating procedures to be applied in such assignments.

  Within the arena of litigation, different factual circumstances often serve to guide valuators in the conduct of their work. For example, litigation related to the meaning of value in the context of an "in-place" equity owner buy/sell agreement will drive different consideration than a matter that includes assertions of equity owner oppression. Moreover, the authors have often participated in assignments where determinations of economic damages are measured by looking at issues of value both "pre" and "post" the actions that are alleged to have caused economic damages.

- ***Employee Stock Ownership Plan Valuations*** – valuations prepared for employee stock ownership plans (ESOPs) are extremely nuanced undertakings that are guided not only by generally accepted business valuation principles and professional standards, but also by guidance from the Internal Revenue Service (IRS) and, importantly, the Department of Labor (DOL).

  ESOPs offer a myriad of tax and economic advantages not available in any other arrangement. ESOPs are particularly useful in facilitating two primary objectives: 1) providing liquidity and diversification for privately-held business owners, and 2) the facilitation of business succession while allowing the Company to continue forward as it had prior to the sale of ownership to the ESOP.

  The ESOP also carries substantial tax and economic advantages for the employee ownership group as will be discussed later in these materials. However, the heavy IRS and DOL oversight makes valuation of ESOP-owned companies a unique exercise.

- ***Accounting-Based Valuations*** – Traditional and historical accounting principles rested on a measure of historical cost. For example, a building purchased in 1980 for $15M was "carried" on the balance sheet of the owner-company at $15M, less any prior-year and current-year depreciation take on that asset. If the building was fully depreciated, the value on the balance sheet nets to zero, even though the building may have an appraised value of $25M. Thus, the balance sheet of the entity understates the value of equity by $25M.

  To remedy this issue, the governing bodies of accounting principles, both within the United States and internationally, have moved closer to presentations of fair value versus historical cost. While the issue addressed in the prior paragraph was illustrative only and remains unresolved, fair value accounting is now an important and growing part of the profession, regularly requiring valuation assessments.

  Those assessments are most common in transaction accounting where purchase price is required to be allocated on a fair value basis. To comply with these rules, accounting based valuation is very often a purpose for which the authors are requested to provide a determination of value and associated consultation. Further, as alluded to earlier, fairness opinions often accompany such assessments.

Special Purpose Valuations

To be sure, the list of expected uses and purpose of valuations can be further refined into categories such as succession planning, insurance planning to protect the company in the event of death or incapacitation of the equity owner(s), to increase management's and the equity owner(s) understanding of the value drivers associated with the business, for funding and financing, for pre-nuptial agreements, and for buy/sell agreements, etc. However, each of these specific uses are a nuanced sub-product of the five broad purposes noted above and discussed throughout today's presentation.

The critical element of a business valuation assignment, as it applies with any specific business valuation purpose, is to ensure that the procedures and protocols utilized align with the requirements of that purpose. These nuanced items include a variety of overriding theoretical and practical aspects of a business valuation and are discussed in each of the sections of today's program. However, to touch quickly on the most important of these, the expected use and purpose of the valuation assignment include:

- Determination of assignment (objective and independent expert versus consultative)
- Identification of client
- Standard or type of value
- Premise of value
- Date(s) of valuation
- Propriety of discounts for lack of control
- Propriety of discounts for lack of marketability
- Consideration of governing documents
- Application of IRS guidance
- Application of DOL guidance
- Application of prior jurisdictional decisions

As the presenters go through each of the following chapters, how these items impact each of the valuations will be more fully addressed. To that end, we have structured the materials as follows to assist today's attendees to more easily understand the impact "purpose" has on each of these cases. As always, the materials are divided into different chapters to allow for ease of understanding and separation of issues.

Special Purpose Valuations

The sections to be discussed in this presentation include:

II. *Understanding the Nuances of Transaction Planning Valuations*

III. *Understanding the Nuances of Estate and Gift Planning Valuations*

IV. *Understanding the Nuances of Litigation Valuations*

V. *Understanding the Nuances of Employee Stock Ownership Plan Valuations*

VI. *Understanding the Nuances of Accounting-Based Valuations*

VII. *Concluding Thoughts*

We appreciate the opportunity to have worked with many of you in the past, and we thank you for your continued support in affording us an opportunity to provide expert economic, financial and valuation services as you represent your clients. We look forward to continuing to work with you.

Please feel free to contact any of the speakers if you have questions that we do not address. Thank you!

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II. Understanding the Nuances of Transaction Planning Valuations

The breadth of the term "transaction planning" can easily be construed to bridge several of the special purpose valuation areas being discussed today. Clearly, when initially contemplating the word "transaction" as it applies to a privately held company, one immediately thinks of a purchase or sale of the company in a change-in-control transaction. To be sure, transaction planning includes such deals; however, the term also includes the purchase or sale of fractional equity ownership interests in an enterprise. In fact, most business commentators view any activity associated with the movement of an equity ownership interest from one party to another to be transactional in nature and part of the transaction planning process.

Another example of transaction planning might be a transfer of ownership through a gifting or lifetime transfer strategy intended to mitigate federal and estate transfer taxes while facilitating a succession plan for senior-generation equity owners. Yet another example might be the issuance of equity shares to employees in return for personal services. A final example might be investigating the merits of selling the shares to an employee stock ownership plan. Each of these crossover purposes will be discussed elsewhere in these materials.

Role of Business Valuators

In looking to the valuation of a privately-held company wishing to explore a potential merger or sale transaction, the first nuance to be addressed is understanding the role of the valuator. In most valuation assignments, the valuator is engaged either as an independent and objective expert (able to testify, if necessary) or as a consultant (an advocate for the selling equity owners). While the authors generally are engaged as independent experts in most assignments, it would not be unusual for us to be engaged as consulting experts with regard to advising equity owners on a potential sale of their company. In many circumstances, the process of preparing an initial valuation for transaction purposes would be followed up with the development of a financial model that would allow for additional iterations of the valuation to accommodate modification of the initial valuation through the negotiation process.

Standard of Value

The next nuance to be addressed, standard of value, is a particularly complex matter in the arena of transaction planning. The *International Glossary of Business Valuation Terms*, sets the definition of Standard of Value as: *"the identification of the type of value being utilized in a specific engagement; e.g. fair market value, fair value, investment value."*[1]

[1] *International Glossary of Business Valuation Terms,* June 2001, as adopted by the American Institute of Certified Public Accountants, the American Society of Appraisers, the Canadian Institute of Chartered Business Valuators, the National Association of Certified Valuators and Analysts and the Institute of Business Appraisers

Special Purpose Valuations

The most common standards of value include fair market value, investment value, fair value as utilized by many state courts, intrinsic value, and fair value used in an accounting context. The two standards most relevant to transaction planning are fair market value and investment value. While these two standards of value are exceedingly common to the profession, they have very unique and critical differences that can serve to produce very wide differences in value.

Fair Market Value

Fair market value is defined in the *International Glossary of Business Valuation Terms* as *"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 arms- length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."*[2]

Fair market value has been theoretically, judicially and commercially defined to include the following key elements:

- The definition assumes a "hypothetical" completed transaction.
- The definition assumes a "hypothetical" buyer and a hypothetical seller.
- The hypothetical buyer is assumed to be the entire universe of likely hypothetical buyers and not any specific buyer.
- The hypothetical buyer is assumed to be under no compulsion to act and is fully knowledgeable.
- The hypothetical seller is assumed to be under no compulsion to act and is fully knowledgeable.
- The hypothetical buyer and the hypothetical seller are presumed to be both willing and able to act.
- The fair market value is deemed to be cash or a cash equivalent.

Investment Value

Investment value differs markedly from fair market value. As defined in the *International Glossary of Business Valuation Terms*, investment value is that "*value to a particular investor based on individual investment requirements and expectations.*"[3]

Investment value is that value under which actual transactions occur as those transactions are not hypothetical. Under this circumstance, actual buyers negotiate with sellers in facilitating an acceptable and agreed

[2] Ibid.,
[3] I bid.

upon purchase price. By definition, such transactions cannot occur without the presence of a specific buyer who brings specific motivations, requirements and expectations. Most often, these specific-buyer attributes are strategic and synergistic in nature and, as a result, are not reflective of a fair market value determination.

The key difference between the two standards of value is encompassed in the word *hypothetical* in the definition of fair market value. In both definitions a sale is presumed to have occurred. Fair market value assumes that the sale has occurred even if it has not (i.e., a hypothetical sale). The investment value standard assumes an actual sale.

What is the difference between the two? A hypothetical sale assumes the entire universe of potential buyers as the participants for the sale, whereas an actual sale includes just one buyer. Thus, in investment value determinations, it is important to consider buyer motivations and advantages. For example, investment value may include a buyer who is able to incorporate synergies or strategic advantages that are not common to the overall universe of hypothetical buyers. Thus, fair market value determinations yield a financial value versus a strategic or synergistic value. Generally, the latter is lower.

Most often, entire businesses are transacted at investment value. However, investment value is difficult to determine with accuracy as sellers are rarely privy to the buyer's financial information necessary to determine what they might be willing to pay for the seller's business. For that reason, these determinations are very often made using a fair market value standard and then use that conclusion of value as a base number from which to set negotiations upward.

Non-controlling fractional interest transactions are most often based on fair market value or some other definition of value in a buy/sell agreement.

Premise of Value

Pursuant to the *International Glossary of Business Valuation Terms*, *"premise of value is a business valuation assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation; e.g. going concern, liquidation."*[4]

Most operating companies will always be valued on a going concern basis for transaction purposes as such a premise allows for the capture of unrecorded assets such as goodwill. In certain cases, generally involving troubled companies, liquidation value will take precedent.

[4] Ibid.,

Special Purpose Valuations

An important aspect of premise of value is the future operations, or transactional circumstances, of the business. The authors have observed challenges to valuation in transactions, especially non-controlling fractional interest valuations, wherein opposing experts wish to invoke likely changes in future performance associated with buyer synergies or strategic advantages.

While this may be proper in the context of an entire company valuation for potential sale purposes, it rarely applies to such non-controlling interest valuations because the buyer in these circumstances is most often the Company or its remaining equity holders. In such cases, the premium purchase price that might be paid by a synergistic or strategic buyer would not be sustainable by the actual buyers as they would not have the ability to create the same synergies or strategic advantages.

Dates of Valuation

Valuation is a point-in-time measurement, so the identification of that date in any business valuation assignment is a critical element of the project. However, valuations associated with entire-company transactions and transaction planning are not specifically tied to a single date. With respect to the purchase and/or sale of an entire enterprise, the process of negotiation is fluid, and the actual negotiated price may or may not align with the valuation work undertaken in contemplation of the potential transaction. In such cases, this phenomenon is most likely the result of synergistic and strategic advantages that were overstated by the seller or items of risk identified in the buyer's due diligence process that resulted in downward modifications to the initial offer price.

Transactions relating to departing fractional interest equity owners may be governed by corporate documents such as an equity owner buy/sell agreement. In these instances the date of valuation is generally set out in the document. In many cases, for ease of determination, the date is set at the quarter or year ending immediately prior to the quarter or year of departure.

Application of Discounts

In transaction planning valuations, discounts for lack of control never apply to a valuation of the entire company, for obvious reasons. Moreover, while determinations of fair market value prepared for other specific purposes, such as estate planning, may include a small discount for a lack of marketability, there is generally no consideration of such discounts in the realm of preparing a valuation of the entire company for transaction purposes. Most often, the small discount noted above for lack of marketability is predicated upon a certain level of transaction costs, leaving the sellers with less than their proportionate share of the gross proceeds. In a transaction, gross value is the critical item, and all transaction costs associated with that transaction will be netted against the gross proceeds at closing.

Special Purpose Valuations

In transaction valuations relating to fractional non-controlling equity interests, the use of discounts in most often guided by the governing documents, especially the equity owner buy/sell agreement. If such a document does not exist or does not clearly set out the definition or standard of value or the application of discounts, both sides must stipulate to the application of the discounts or defer to state law where the dispute is located.

If state law sets the standard of value as fair market value, and the term is defined as set forth earlier in this chapter, both discounts would apply (if merited) to the valuation of a fractional non-controlling interest. However, if state law sets a different standard, the application of discounts will vary.

Governing Documents

Governing documents may include provisions that run adverse to the goals of the sellers to engage in a transaction for the entire company. Often, these provisions can be modified by the ownership group prior to entering into a transaction or undertaking transaction planning. However, the authors have encountered circumstances where transaction planning had to include compliance with certain provisions of the agreements. Rarely, however, have we observed governing documents serving as a barrier to entering into a transaction and, as such, these agreements generally have little impact in valuations associated with transaction activities.

The exception is the equity owner buy/sell agreement.[5] These agreements frequently impact various aspects of the valuation of fractional equity owner interests for both entering and departing equity owners. Therefore, it is critical to have a quality agreement that is well understood among the equity ownership group. It is important to note that facilitating an inbound or outbound fractional equity owner interest is actually a cleaner and more efficient transaction if it is based upon the language and guidance in a strong buy/sell agreement.

Summary

Valuations prepared for the purpose of exploring a transaction for an entire company or the entrance or departure of a fractional interest owner can be exceedingly complex. However, the fact that such valuations are most often prepared for members of management or the ownership group generally allows a much greater level of flexibility in both the underlying assumptions and the procedures ultimately selected and applied.

[5] For more information, download our previous CLE presentation on this topic at https://gyf.com/download/seminar-materials/cle-books/Buy-Sell-Agreements-10-5-17.pdf

III. Understanding the Nuances of Estate and Gift Planning Valuations

Valuation is at the heart of any planning in the estate and gift tax arena. Estate, gift, and generation skipping transfer taxes represent a transfer tax based on estate asset values or on the value of a gifted asset. The appraised value determined by a credentialed business valuator will have a direct impact on the resulting tax liability to the taxpayer or taxpayer's estate.

The Internal Revenue Service, through its releases, rulings and regulations, has provided a significant amount of technical guidance intended to address many complexities involved in the valuation of assets, specifically privately held business ownership interests. At the cornerstone of all of this guidance, and perhaps the most often quoted citation in all of business valuation, is Revenue Ruling 59-60. In addition to the guidance provided by Rev. Rul. 59-60, valuators consult many sources for guidance related to estate and gift tax valuations, including the Internal Revenue Code, Treasury regulations, additional revenue rulings, revenue procedures, and case law.

The current federal estate tax rules allow for the transfer of nearly $11.6 million per individual, which doubles if a taxpayer splits the gift with a spouse. The exclusion is adjusted each year for inflation. Should the value of the assets transferred fail to exceed the lifetime exclusion threshold, no tax liability will be created as a result of the transfer.

Qualified Appraiser

Internal Revenue Code section 170(f)(11) requires that a valuation for these purposes be performed by a "qualified appraiser". Specifically, the code states that a qualified appraiser is an individual who: (I) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary, (II) regularly performs appraisals for which the individual receives compensation, and (III) meets such other requirements as may be prescribed by the Secretary in regulations or other guidance. In addition, the Code requires the taxpayer to provide a "qualified appraisal", conducted by a qualified appraiser in accordance with generally accepted appraisal standards and other guidance. The code further defines the contents that are required for an appraisal report to be considered a qualified appraisal.

In most cases, the valuator is retained by the estate planning attorney. This practice allows for protection though attorney-client privilege throughout the valuation engagement. Alternatively, the valuator may be engaged directly by the taxpayer or by the executor or executrix of an estate.

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Standard of Value

The standard of value required for all estate and gift tax valuations is fair market value. Fair market value, as previously discussed, is a commonly accepted and strictly defined standard of value. The fair market value standard of value was discussed in detail earlier in this publication, however, it is important to reiterate a few key factors related to its definition:

- Fair market value is a financial value rather than a strategic or investment value
- Fair market value assumes a willing buyer and willing seller
- Fair market value assumes no compulsion to buy or sell the subject property
- Fair market value contemplates the entire universe of buyers

From a practical standpoint, the fair market value standard of value is the most taxpayer-friendly standard of value. That is, under the investment (or strategic) standard of value (the standard that drives merger and acquisition activity), the value of a business enterprise is almost always higher than under the fair market value standard. As a financial value, the fair market value standard represents the floor value that any willing seller would reasonably accept in the open market, as it does not include positive impacts to value for specific buyer synergies.

Premise of Value

Most often, valuators will work under the going concern premise of value, assuming that the subject company will remain into the future and existing management will maintain the character and integrity of the company. The going concern premise of value is almost always utilized when the subject of the valuation is a profitable operating company.

A liquidation premise would provide the net amount that would be realized if the business terminated, and the assets were sold piecemeal. A liquidation premise of value may be utilized in the event that the entity under consideration is an asset-holding entity rather than an operating company.

Date of Valuation

The date of valuation in estate and gift tax valuations is a critical factor in the tax liability ultimately borne by the taxpayer (or estate). The date of valuation will determine what information will be considered by the valuator when determining the value of the subject ownership interest.

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In a gifting situation, the date of valuation is usually a strategic date adopted by the taxpayer through guidance from legal counsel. The factors that will have the most significant impact on selecting a date of valuation for gifting purposes are:

- ***The current tax environment and proposed changes to estate and gift tax laws.*** The most recent changes to the laws surrounding estate and gift tax were included in the Tax Cuts and Jobs Act (TCJA), which was signed into law at the end of 2017. The TCJA included many taxpayer-friendly provisions, including provisions related to the estate and gift tax realm, where the provisions serve to reduce the potential tax liability of estates and those choosing to gift business interests to others. It is our experience, that proposed or expected changes to tax laws, whether potentially increasing or decreasing tax liability associated with estate and gift tax planning, drives an increase in planning activity. For instance, at the end of 2012, many tax cuts enacted by president George W. Bush, including reduced rates associated with estate and gift tax planning, were set to expire. This anticipated "fiscal cliff" increased planning activity as taxpayers gifted ownership interests in expectation of increasing tax rates.

- ***The current health, position, and outlook of the business under analysis.*** Determining the value of a business requires an understanding the company's historical and expected future financial performance, its operational strengths and weaknesses, as well as any other company-specific characteristics that would impact an investor's perception of the risk versus reward analysis of an investment in the company. Understanding the current position of the company and its future outlook at the date of valuation will provide investors comfort related to the return that they should expect to receive subsequent to their investment. That return must be risk-adjusted at the date of valuation to discern how it translates to value.

- ***The current state of the economy, the industry in which the company operates, and other value drivers.*** Valuation is always forward-looking as the hypothetical universe of buyers envisioned in the fair market value standard is principally concerned with the future return they will receive on their investment in the company considering the risks inherent with that investment. Factors that impact the risk profile of an investment in any business go beyond the day-to-day operations and performance and include, more broadly, the relative health of the economy and the strength of the industry in which the company competes. Both of these factors can impact the future operating performance of a company as well as the relative risk of an investment in the company when considering alternative investment options. A more optimistic or pessimistic outlook of these factors and how they impact the riskiness of an investment in the company will either positively or negatively impact value.

When determining when a gift should be made, each of these factors, and their eventual impact on value, must be considered. In our experience, determination of the date of valuation in a gifting situation requires a meeting of the minds between the taxpayer/owner, management of the subject company, the taxpayer's legal team, as well as the valuator, as each will bring forth a unique perspective of the information which would be considered in the valuation analysis based upon potential effective dates of valuation.

In relation to a valuation for estate tax purposes, the decedent's estate will utilize a date of valuation as of the date of death of the decedent. Alternatively, IRC Section 2032 allows the executor or executrix of an estate to elect an alternative date of valuation, six months after the date of death.

Whether the executor/executrix of an estate is determining whether to select the alternative date of valuation or a taxpayer is determining what date of valuation to use for gifting an ownership interest in a business, the factors that will impact the decision will remain the same. The value of any subject ownership interest will change over time. In isolation, the taxpayer or taxpayer's estate may prefer to use a date of valuation at which value of the subject business it as its lowest, reducing the potential tax liability. Alternatively, beneficiaries would prefer to receive or inherit the ownership interest at a date at which the value of the subject business is at its highest, as it would reduce any capital gains tax due to the beneficiary upon the eventual sale of the business. Each of the stakeholders involved in an estate or gift scenario should be considered in totality in order to select the date of valuation that best aligns with the goals of the estate plan.

Subject Interest and Valuation Discounts

The applicability of valuation discounts, as is the case in any valuation, will be driven by the standard of value, the subject interest under consideration, the bundle of rights associated with the ownership interest, and the valuation methodologies employed by the valuator. Valuations prepared for a decedent's estate will be prepared to quantify the value of the ownership interest held by the decedent at their date of death. Alternatively, valuations prepared for gifting purposes will be prepared to quantify the value of the ownership interest that will be gifted in relation to the planning strategies.

When considering the fair market value standard of value in relation to estate and gift planning valuations, all attributes of the subject ownership interest must be considered. The ownership attributes of the interest under consideration will determine the applicability of valuation discounts as the discounts aim to capture the impact on value resulting from control (or lack thereof) and marketability attributes of the ownership interest. Due to specific characteristics requiring the application of discounts for both a lack of control and a lack of marketability, minority ownership interests in privately held businesses are generally worth much less than their proportionate share of the overall business value. In other words, the sum of the parts may not add up to the whole.

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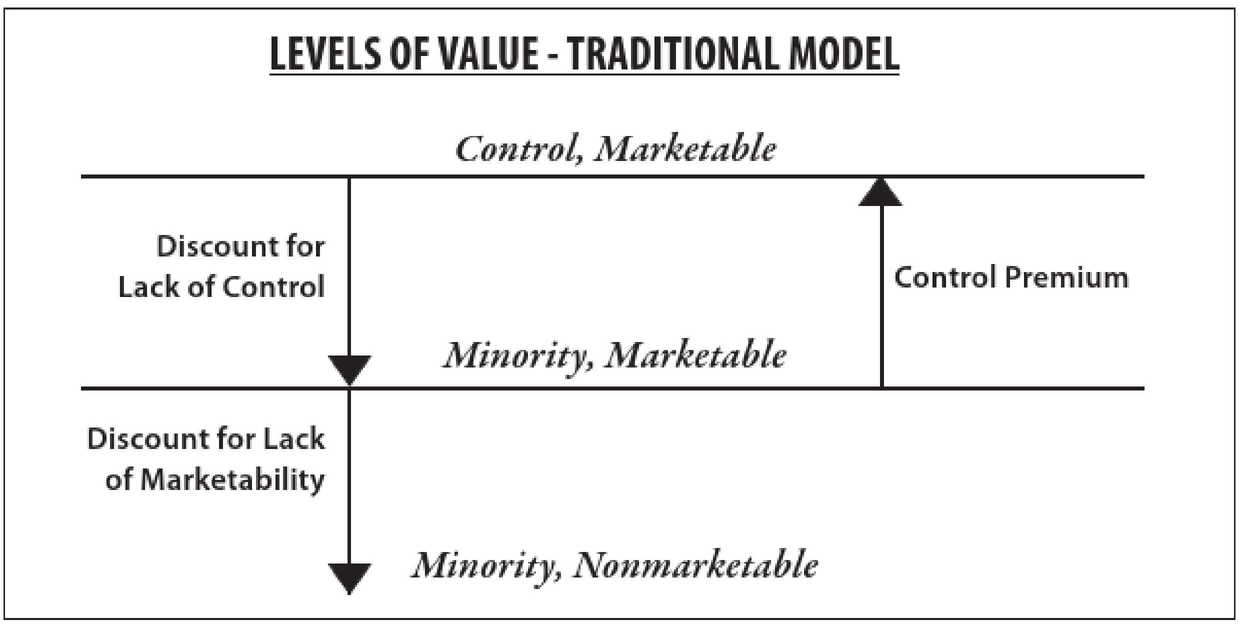
Historically, for estate and gift tax purposes, the business valuation and finance communities have assumed three basic levels of value:

- Control, marketable interest value
- Minority, marketable interest value
- Minority, nonmarketable interest value

The tradition levels of value can be illustrated in the following graphic:



The use and application of discounts is most often guided by the governing documents including the operating agreement, partnership agreement, shareholder agreement, or buy/sell agreements. Such documents detail the restrictions placed upon fractional ownership interests related to both control as well as (in)ability to sell or liquidate an ownership interest. It should be noted, however, that agreements that are extremely restrictive may be at risk of an IRS challenge of the valuation discounts under IRC Section 2703, which provides guidance to valuators on how restrictions within governing documents should be considered.

Of all the intrinsic characteristics related to an equity interest, arguably none may be more important than the element of control. Widely accepted theory within the business valuation community holds that an investment in a privately held company is worth the present value of all of the future benefits inuring to the holder of that equity interest. If the equity holder has a control position, he or she can accelerate the receipt of those future benefits and, through management and operational initiatives, take direct steps to enhance the future benefits – or at least the probability that they will be generated.

On the other hand, a minority or non-controlling position in a privately held company is generally held at the great risk of being subject to the judgment, ethics and management skills of the controlling shareholder(s). Depending on a number of items, the impairment of value can be significant in this circumstance.

Court decisions and rulings employing discounts for lack of control have become the standard over the years, applying these principles not only to stocks, but other types of property as well. The application of these discounts is also broadly accepted by the business valuation community in "non-estate/gift tax" venues.

Protection from many risks attendant to holding a minority interest in a business can be controlled in the public stock market by selling the equity holdings, should the holder decide that management actions are elevating his or her risk beyond an acceptable level. This same ability to liquidate (convert into cash) an interest in a privately held company rarely exists. Moreover, due to size and other specific company nuances, as well as a lack of a perfect market mechanism for disposition, risk attendant to a lack of liquidity or of marketability can often be an issue for even a control interest in a privately held enterprise.

The attribute of marketability attendant to any ownership interest must be considered. The ability to convert an investment from an illiquid asset to cash is an ownership characteristic of considerable value. Perfect marketability provides the ability to convert an asset into cash in a very short period of time. In the realm of equity investments, perfect marketability is presumed to be present in the public stock markets, in which an equity position can usually be converted into cash in a few business days. Such conversion capability reduces investment risk significantly, as the ability to change equity positions into cash quickly often allows the opportunity for the protection of asset values. Often, when this trait is missing, an investor is subject to substantially higher risk, and valuation of the attendant equity interest must be adjusted accordingly

It is well-recognized within the business valuation community that discounts for lack of marketability apply to controlling interests as well as non-controlling interests. It is also commonly accepted that such discounts are often considerably lower for controlling interests than for non-controlling interests.

Quantification of the discount for lack of marketability is an ardent task, even for the most seasoned valuation professionals. Significant research has been developed over the last few decades in an attempt to quantify the phenomenon of illiquidity as it applies to a specific investment. However, valuators continue to struggle with the reconciliation of the available research to the attendant ownership interest under valuation. A logical path from the research to the ultimate discount selected is imperative to attain the proper conclusion of value.

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When gifting shares in a privately held enterprise, it is common practice to make gifts at the minority, nonmarketable level of value. Doing so allows the taxpayer the benefit of leveraging both a discount for lack of control and lack of marketability. Such strategies should be considered during the estate planning phase and revisited as changes occur either in the subject business or within the applicable tax laws.

Other Considerations

In determining the value of privately held business interest, valuators must stay current on existing and proposed Treasury regulations that can impact the risk of challenge by the Treasury Department, and more specifically the Internal Revenue Service. Additionally, valuators must keep the pulse of current IRS challenges to understand what areas are under scrutiny in an effort to minimize risk of challenge.

The IRS has released three job aids related to business valuation. The job aids were prepared as internal documents that were to be distributed to the valuation professionals employed by the IRS to allow for consistent interpretation of the IRS's stance on various valuation topics. The first job aid, which addresses discounts for lack of marketability, was not intended to be released to the public, but was leaked in the summer of 2010. As a response, the IRS released an official version of the job aid to the public in September of that year. In 2014, the IRS published two additional job aids, addressing reasonable compensation and valuing non-controlling interest in S Corporations. While the job aids are not authoritative, they provide guidance to the valuation community on how IRS valuation professionals review positions taken by valuators. As such documents are released (or leaked), the valuation community must review and incorporate the information in the valuation process.

For many years, Family Limited Partnership (FLPs) have been used in the estate and gift tax planning arena as a means to centralize family assets in one vehicle for control and management, limit liability, and allow for transferability of ownership. The validity of FLPs has long been a target of attack by the IRS. From a valuation perspective, the IRS is primarily concerned with the discounts taken in appraising a non-controlling, nonmarketable limited partner interest in an FLP. Having the parties respect the partnership, both organizationally and operationally, should serve to minimize IRS scrutiny. Proper analysis at the front end of the process, as well as putting together a well-crafted partnership agreement, can go a long way toward mitigating these risks.

Conclusion

Privately held business ownership interests often represent the taxpayer's most substantial asset. As such, the estate planning strategy must be considered carefully to ensure that issues of value and transfer of interests are supportable and defensible against tax authority challenge. The use of seasoned, credentialed valuation experts, will allow legal professionals to have a higher comfort level with the defensibility of implemented strategies.

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IV. Understanding the Nuances of Litigation Valuations

The need for valuation in a litigation setting typically involves shareholder oppression, contentious shareholder buyouts, or damages calculations where there is a loss of value of a business or particular asset of a business. As members of the legal community are acutely aware, every case turns on its own set of specific facts and circumstances, and those attributes considered by the valuator are generally unique to each case. It is critical that the valuator understands what is required in the jurisdiction where the case is being tried to ensure that he/she is providing the trier of fact with the appropriate value assessment. The authors of this material have been involved in the preparation of valuations for shareholder oppression, shareholder buyouts and damages cases.

Shareholder Oppression

The concept of shareholder oppression presupposes a position of equity capital ownership in a business enterprise that constitutes both legal and factual control to mandate enterprise-level decisions over a position of equity capital ownership that legally and factually lacks such control to mandate or veto such decisions. The legal matter that sits at the center of any shareholder oppression matter is the majority or controlling shareholder's(s') or shareholder group's(s') misuse of that control in taking actions that allegedly prejudice those shareholders lacking the attribute of control in their ownership.

The issue of shareholder oppression arises in the context of privately held businesses. Certainly, a non-controlling or minority owner of an equity interest in a publicly traded enterprise can feel as if decisions are being made that are unfair to him/her, or that management of that enterprise has engaged in "bad acts" harmful to the company and the non-controlling or minority owner. However, in these instances, the investment attribute of "marketability" generally serves to indirectly protect the equity owners from the repercussions of these actions.

There are any number of majority equity owner actions that may be alleged in such matters as having been harmful to the minority equity owner group. While not an all-inclusive list, the following offers the more commonly-noted actions, or lack thereof, that often crop up in shareholder oppression cases:

- A failure by the company to declare or pay dividends or make distributions to minority equity owner;
- A failure to pay "agreed-upon" compensation or other monetary remuneration to minority shareholder;
- Withholding critical operating, financial or business information from minority equity owner;
- Dismissal of minority equity owner as an employee;

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- Dismissal of minority equity owner as a member of the board of directors;
- A failure to notify minority shareholders of meetings that they are entitled to attend;
- Taking actions that allow for unjust enrichment of the majority owners;
- Attempting to push the minority equity owner out of the company.

Valuation

Generally, the remedies in an oppression proceeding are most often reduced to an economic platform comprised of a monetary resolution. These remedies often include the determination of monetary damages resulting from actions taken by the majority equity owners that ultimately serve to misuse corporate assets and/or unjustly enrich majority equity owners.

Though it is the experience of the authors that many of these determinations involve a specific-matter calculation, such as addressing excess economic enrichment actions including excess compensation, rent or other corporate expense; sometimes, the actions can only be measured in terms of shareholder/equity owner value before and after the alleged majority equity owner oppressive actions.

Valuations in this context are generally intended to assist counsel and their client(s) in assessing the estimated economic impact of the alleged action. To make this determination, depending on the controlling state law statutes, the general goal in remedying such matters is to ensure that the plaintiff minority equity owner is returned to the same financial position he/she was at prior to the alleged oppressive action(s) by the majority equity owners.

Standard of Value

The standard of value for equity owner oppression cases is generally governed by state law. The two standards that are primarily utilized in relation to shareholder oppression cases are fair value and fair market value (or a variation thereof).

In the Commonwealth of Pennsylvania, the Pennsylvania Code, which is often cited as the source for valuation-related issues, states that the value of an oppressed shareholder's ownership interest is equal to: "*The fair value of shares immediately before the effectuation of the corporate action to which the dissenter objects, taking into account all relevant factors, but excluding any appreciation or depreciation in anticipation of the corporate action.*"[6]

[6] 15 Pa. C.S §1572

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Many states look to the *Model Business Corporation Act* (MBCA) for guidance on many valuation-related issues. The MBCA defines fair value as follows:

"Fair value" means the value of the corporation's shares determined:

(i) immediately before the effectuation of the corporate action to which the shareholder objects;

(ii) using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and

(iii) without discounting for lack of marketability or minority status except, if appropriate, for amendments to the articles pursuant to section 13.02(a)(5).[7]

While fair value is often the standard used for equity owner oppression cases, the definition of fair value is usually set forth in its relation to fair market value from a conceptual standpoint. That is, in most cases, fair value is understood as the fair market value of a specific ownership interest, without consideration of discounts for lack of control or lack of marketability, as these adjustments would be inequitable. Said another way, fair value can be defined as the minority interest's pro-rata share of the value of the company as a whole.

The implication in the latter definition is, again, that adjustments for lack of control are not considered as to prevent unfairly enriching the controlling shareholder. The following chart describes the differences between the fair value and fair market value standards.[8]

Fair Market Value	**Fair Value**
Willing buyer	*Not always a willing buyer*
Willing seller	*Not a willing seller*
Neither under compulsion	*Buyer not always compelled; seller under compulsion*
Assumes a typical hypothetical buyer and seller	*The impact of the proposed transaction is not considered; the concept of fairness to the seller is a possible consideration*
A price equitable to both	*A concept of "fairness" to the seller, considering the inability to keep the stock*

[7] *Model Business Corporation Act*, 2000/01/02 Supplement, 3rd Edition, American Bar Foundation, p. 143 http://www.lexisnexis.com/documents/pdf/20080618091347_large.pdf

[8] Trugman, Gary R. *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses.*

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Fair Market Value	Fair Value
Assumes buyer and seller have equal knowledge	*No such assumption*
Assumes reasonable knowledge of both parties	*No such assumption*
Applicable to both controlling interests and minority blocks	*Applicable only to minority blocks*
Applies to all federal tax valuation	*The most common value standard in state dissenting and oppressed shareholder statutes*

Fair market value is an objective standard, while fair value is an equitable standard. Note that in the event that organizational documents that govern the standard of value exist, they may direct the business valuator to the agreed-upon standard of value. However, if the valuation assignment is related to a shareholder oppression suit, Pennsylvania law plainly provides that oppressed shareholders/equity owners are entitled to the "fair value" of their equity interests.

Using the fair value standard, as opposed to the fair market value standard, will result in a higher value to the minority shareholder. However, the value under the fair value standard will still be less than the value determined under a strategic or synergistic value standard, which takes into account buyer-specific synergies unattainable by the Company in its current form. As such, the fair value standard strikes a balance between awarding a controlling shareholder who forced out a minority shareholder (if the fair market value standard were used) and incentivizing litigation by a non-controlling shareholder attempting to capture value from controlling shareholders, which is unattainable without synergistic acquisition (under a strategic value standard).

Selecting the correct standard of value and applying it properly is critical in a valuation assignment, as each standard will yield different opinions of value. The standard of value dictates the methodologies that will be performed, as well as the discounts and premiums that may be applied. This is often challenging in a litigation setting, as the correct standard of value varies depending on the nature of the case. As a result, it is important that legal counsel is consulted regarding the standard to be used.

Premise of Value

Another determination that must be made for a valuation assignment related to equity owner oppression is the applicable premise of value. This is an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation. Premises of value include either going concern or liquidation.

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Most often, valuation professionals work under the "going concern" premise of value, meaning that the existing management of the subject company will remain into the future and will maintain the character and integrity of the company. Rooted in this premise of value is the assumption that the ongoing operations of the business, and the cash returns generated by those operations, drive the value of the company. This premise of value most-closely aligns with the concept that all value is forward-looking, and that the value of any investment is the present value of all future benefits that will accrue to it.

A liquidation premise would provide the net amount that would be realized if the business was terminated, and the assets were sold piecemeal. Liquidation can be either orderly or forced. In certain instances, equity owner oppression cases can result in the dissolution of a company. Though rare, in some cases the court orders that a company be dissolved, even though it had a history of strong performance of profitability. In most states, a shareholder buyout option is preferred to dissolution. Thus, the going concern premise of value is generally utilized.

However, it should be noted, that in Pennsylvania, the court has allowed the dissolution of a business if it is in the best interest of the oppressed shareholder. According to 15 Pa. C.S. §1981, if "the acts of the directors, or those in control of the corporation, are illegal, oppressive or fraudulent and that it is beneficial to the interest of the shareholders, that the corporation be wound up and dissolved." While this does not necessarily directly impact the valuation of the equity owner's business interest, it should be considered by the oppressed shareholder in understanding his or her options in resolution of an oppression case.

Date of Valuation

In a shareholder oppression case, the date of valuation is usually determined by the court, legal statute, or court filing. For this reason, valuators often lean on legal counsel for guidance on the appropriate date of valuation to be used in the representation of their client.

While legal counsel will, ultimately, have the final say in the determination of the appropriate date of valuation, generally it will be one of a few specific dates, depending on the facts and circumstances of the particular case. The date on which the oppressed equity owner files a complaint with the court can be used as the date of valuation. This date is utilized, as it is the date at which the oppressed party made it formally known that he/she believes he/she has been wronged.

Shareholder oppression, by nature, can occur over a period of time, not necessarily at one specific point in time. For example, if a corporation has not paid dividends because a controlling shareholder takes a salary that is above reasonable compensation, the oppressive act has likely happened for multiple years. In such instances, the court may need to consider the impact of various dates to determine the most appropriate effective date to use.

In *Viener v. Jacobs*, 834 A.2d 546, 556 (Pa. Super. Ct., 2003), the court determined to use a date of valuation predating a post-squeeze-out decrease in the company's value, as it was determined to be in the best interest of the oppressed shareholder.

If valuation professionals are engaged on each side of an oppressed equity owner dispute, it is important that each uses the same date of valuation. Whether the date is agreed to by the shareholders, or determined through governing documents or legal precedent, consistency in application between valuation professionals is critical. Inconsistency between valuators in which date is utilized will render their opinions incomparable, requiring additional professional time to remedy – generally at the expense of the parties to the action.

Valuation Adjustments

In consideration of the specific ownership attributes of an equity instrument, valuators routinely determine whether it is appropriate to apply specific discounts or premiums to the value calculated under each of the three broad valuation approaches (income, market, and asset-based).

Depending upon valuator inputs into the mathematical models under the various approaches, each may produce a valuation conclusion that differs in relation to the subject equity interest. That is, the application of a discount or premium may be warranted to bring the calculated value under the applied approach to the targeted or required level of value.

The attributes most commonly addressed by discounts or premiums are related to control, or lack thereof, and those related to a lack of liquidity or marketability. A minority interest lacks the ability to control the operations of the business without the support of additional shareholders. Additionally, a minority interest in a privately-held business lacks the ability to quickly liquidate ownership interest. For these reasons, valuators often must determine if a discount for lack of control and a discount for lack of marketability/liquidity are applicable.

In most fair value cases, discounts are not applied when calculating the value of a minority ownership interest. However, depending on the jurisdiction, the following has been observed when applying fair value:

- Disallowing both discounts;
- Allowing both discounts;
- Allowing only a discount for lack of control; and
- Allowing only a discount for lack of marketability.

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In Pennsylvania, it has been observed that in employing the fair value standard, valuations appear to calculate fair market value without the consideration of either a discount for lack of control or lack of marketability. As is often the case, the onus is on the valuator to educate legal counsel on the nuances of valuation adjustments, but the final determination of their applicability will fall in the hands of counsel.

Final Thoughts on Shareholder Oppression

Various issues in equity owner oppression cases need to be considered at the onset by legal counsel and the valuator. It is important for legal counsel to understand not only the various issues at play, but also the potential impact of these issues to the clients and their cases. Determining the proper standard of value, and the methods that will be applied, are critical to an efficient valuation determination. For these reasons, legal counsel and the valuator must work together throughout the case to ensure the best possible outcome for clients.

Corporate Divorce

The process of shareholder buyouts may lead to contentious situations, which evolve into litigation; thus, labeling them "corporate divorce". In many cases, exiting equity owners feel as if they were mistreated. The process of corporate divorce is far more challenging, costly, and time-consuming without quality governing documents that dictate the means by which these transactions are to be effected.

The primary motivation leading to a corporate divorce is lack of focus on critical organizational documents, specifically, those provisions in organizational documents addressing the departure of an equity owner. The critical nature of these documents is simply identification of equity owner rights and obligations. By virtue of the terms and content of each, there may be adequate guidance therein to accomplish resolution of many, if not all issues of concern in a corporate divorce.

Such documents might provide the process by which disputes among shareholders can be resolved. Furthermore, many businesses have organizational documents that provide for the means and methods by which any particular block of equity ownership might be valued. Additionally, the terms and conditions for accomplishing the repurchase of equity shares are often present, so the methods by which the selling shareholder will be paid for his or her shares are clear and straightforward.

Unfortunately, much of what is found in dated documents reflects less-than-useful information. A lack of clarity in definitions, as those definitions have advanced and gone through a refinement process, generally makes interpretation difficult and opens the door to varying interpretations among the equity owner group. Such openings often pave the way for conflict and interfere with issues resolution.

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Equally important in the consideration of these documents are those provisions that dictate termination scenarios, as well as related issues such as, employee/equity owner recourse, severance or separation payments (amount and term/timing of payments), covenants-not-to-compete and fringe benefit matters, future protections of business knowledge and business confidentiality (all in addition to the equity owner interest transfer). Other critical items to be considered at inception of the business might include restrictions on transferability of equity owner interests and rights of first refusal, for example.

Not all corporate divorces among equity owners are driven by negative underpinnings and perceived malfeasance by one party against the other(s). That does not mean, however, that these instances are always without controversy. Often, equity owners depart a business for life events that go well beyond the walls of the business itself or equity owner relationships. While the breadth of these reasons can be very broad, the common thread from the position of the diluting or exiting equity owner, is a critical need for cash. Thus, any need for cash may serve as a driver to seek exit from a business enterprise.

Examples of life events that might trigger an equity owner dilution or exit (again, not intended to be exhaustive), might include:

- College funding;
- Marital dissolution;
- Illness;
- Retirement;
- Alternative investment or redeployment of assets; and
- S corporation election

Given the fluidity and dynamics of equity owner split-ups, the authors have rarely observed success in resolving these matters in short order. That is not to say that such instances do not exist. However, the complexity of the economic determinations and the complexities of the legal process, combined with the dynamics of betrayal and mistrust (real or perceived) tend to exacerbate an already difficult situation. In such cases, the length of time to accomplish fair and equitable resolution can be significant.

Buy/Sell Agreements

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.

An example of the types of issues that can be troublesome in outdated and/or poorly crafted documents can easily be observed in the buy/sell agreement. While such organizational documents are common, many of the specific provisions within the buy/sell document can lack the requisite clarity and definition to be useful to avoid conflict at relevant action dates. That being said, a well-crafted buy/sell agreement is a must for all businesses and should address equity transfer issues in a manner that is understood by all parties at inception of the business and thereafter.

Advantages of Buy/Sell Agreements

There are many motivations to adopt a buy/sell agreement, including the following:

- It allows for an orderly transition of ownership at certain terms, if specifically-identified events (triggering events) occur, by setting the purchase price or formula for determining the price.
- It provides a guaranteed market for an ownership interest upon occurrence of a triggering event.
- Clarity in the agreement minimizes the potential need for adversarial legal intervention.
- Funding mechanisms may minimize the business' or purchasing owner's stress relating to payment for the selling owner's interest.
- Having the agreement in place provides income protection and financial security.
- It provides protection from sharing control of the business with an inexperienced or untrustworthy outsider.
- It can provide certainty and continuity.

Detriments to Buy/Sell Agreements

The lack of clarity relating to any number of provisions in a buy/sell agreement can lead to owner disappointment, controversy, and even litigation. It may be discovered upon a triggering event that there is a conflict between the language in the agreement and the intentions of the parties. It is critical for all parties to the agreement to understand how the agreement will operate at the appropriate dates in order to determine prices and terms for future transactions.

Problem areas in the Agreement relating to valuation matters may include: how the value is to be determined; the valuator selection process; valuator qualifications; procedures that might arise in the event that the initial valuation is deemed unacceptable by one of the parties; the party(ies) responsible for payment for the valuation; the standard (or definition) of value to be used; the valuation date; whether discounts are to be applied; and how the repurchase is to be funded. Each of these items will be discussed later in these materials, but suffice to say, that a lack of absolute clarity in any area is likely to result in an equity dispute at some point in the future.

The funding device is critical to the parties' ability to transact the repurchase envisioned in the agreement. Oftentimes, too little focus is provided to this aspect of the buy/sell agreement. There are three common funding mechanisms including insurance, sinking funds and pre-agreed payment terms. What often happens is that the amounts of the funding mechanisms are not adjusted as value changes, leading to issues upon a triggering event.

Valuation

A routine valuation matter could turn into a very high-anxiety and intense experience for all parties involved. One of the most crucial questions to ask all parties to the agreement is the following: if a triggering event occurs, will the valuation mechanism in the buy/sell agreement accomplish the objective of providing a price for the company's stock at the level the partners/shareholders agree to be reasonable?

When a business valuator is engaged to determine the price of the selling owner's shares, certain areas must be addressed in the buy/sell agreement to provide proper framework and guidance to the valuator. The more an agreement elaborates on these key areas, the less likely it is that uncertainty and controversy will result. It is always a best practice to have the valuation-related language in a buy/sell agreement reviewed by a qualified business appraiser. A very important element of the provisions within the organization's documents are those pertaining to how the equity interests of that entity are to be valued as well as the many valuation-related issues that might arise, including the standard of value to be used, the date of valuation, and the definition of events that might trigger such a valuation. Valuation is often the most perplexing matter to be resolved in a corporate divorce.

The same business valuation process, approaches and methodologies will be applied in a shareholder dispute as they are applied in connection with other types of valuation engagements. However, attorneys and their clients should be mindful of several aspects of business valuation that are unique to shareholder disputes.

Special Purpose Valuations

- ***"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. 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 are 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.

  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. Note, major changes in operations or company activities may require consideration and adjustment in the formula, or its conclusions.

  Finally, 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.

Special Purpose Valuations

Standard of Value

Standard of value in corporate divorce is typically outlined within the provisions of the buy/sell agreement. 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.

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. This standard or definition of value most closely aligns with the economic value of the equity interest being acquired from the outgoing equity owner. There have been many instances wherein the standard of value stated is fair market value without consideration of discounts for lack of control and lack of marketability.

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.

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.

Lastly, in the instance where a corporate divorce crosses over into the realm of shareholder oppression, fair value is the statutory standard utilized in most states.

Premise of Value

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."

Special Purpose Valuations

The liquidation premise, not often used, 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).

Date of Valuation

The date of valuation is set by language in the buy/sell agreement and is generally determined 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).

The various dates of valuation often include the date of notification, the date of the triggering event, the date of the equity owner's departure, last quarter or year-end, or other current date.

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 that 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.

Valuation Adjustments

Valuation adjustments in a corporate divorce follow the provisions for the standard of value in the buy/sell agreement. As noted, fair market value is widely used and would include both discounts for lack of control (for minority interests) and discounts for lack of marketability (or lack of liquidity for controlling interests). However, there are instances where the standard of value is fair market value without consideration of one or both discounts for lack of control and lack of marketability. This latter treatment aligns with the fair value standard.

Final Thoughts on Corporate Divorce

The road to resolution in a corporate divorce is one filled with obstacles. Emotions, personalities, bad feelings, poorly-crafted or outdated governing documents, a lack of open accessibility to financial and operating records, complex financial matters and, perhaps, even more-complex legal matters, combine to make work in this area exceedingly challenging. Understanding the nuances of this type of valuation assignment will certainly enhance the effectiveness of the valuator as well as ensure a fair resolution on behalf of legal counsel's client under such difficult circumstances.

Special Purpose Valuations

Marital Dissolutions

Family law courts are generally seeking to establish equitable valuations in connection with the division of the marital estate. For many divorcing couples, a closely-held business represents one of the largest marital assets; one in which there is no readily available market pricing.

Valuation

Valuations performed in a marital dissolution setting are state-specific, and in some cases jurisdiction-specific. There are a number of nuances with respect to valuations for marital dissolution purposes, which make it very different from valuations performed for other litigation purposes. Such that, it makes it difficult for a valuator to dabble in this area.

Standard of Value

The valuator must gain a clear understanding of the specific definition (or standard) of value that will be used in a divorce setting. In the state of Pennsylvania, the standard of value in marital dissolution cases is fair market value. Fair market value is often referred to as the *value in exchange* for subject closely-held business. The authors of this material have experienced that fair market value may be the stated standard in other jurisdictions; however, it may not be the typical definition used in other applications, including estate and gift tax purposes.

Some states' marital dissolution statutes refer to fair value. Since fair value is generally a legal standard, the courts have discretion in the determination of value. In certain states, when valuing a closely-held business for purposes of marital dissolution, case law specifically disallows any discounts for lack of control and lack of marketability.

Intrinsic value is a standard of value often associated with publicly traded securities. It refers to the pure value of a security developed by an analyst, as opposed to its publicly traded value. In a divorce setting, this standard, as it was previously defined, would not be used. We have found that intrinsic value is used interchangeably with investment value – the value to the holder.

Failure to apply the proper standard of value will result in the valuation being excluded, discounted or ignored by the judge or master. Legal counsel should always be consulted in defining the standard of value for the valuation professional, as well as case law in the particular jurisdiction. Appellate and supreme courts are generally reluctant to overturn trial court decisions relative to valuation of closely-held businesses, unless there is a clear abuse of judicial discretion.

Special Purpose Valuations

Premise of Value

Typically the premise of value in a marital dissolution is going concern. However, the definition of going concern includes consideration of intangible value. Most divorce courts will recognize the inclusion of goodwill, however elements of goodwill, including personal goodwill, are eliminated from inclusion in the marital estate.

A liquidation premise of value, forced or orderly, would only be used in a marital dissolution proceeding in the same instances or under the same circumstances as a valuation for any other purposes. This includes when the business is in or starting the process of liquidation, or the values produced under the income and market approaches are less than the value recognized upon liquidation.

Date of Valuation

Assigning a date of valuation for a business in a marital dissolution can have a significant impact on its value. Each state will have its own specific guidelines as it relates to date of valuation. Possible dates include the date of separation, the date the divorce complaint was filed, and the current date. Note that the date of separation is in an important date of valuation, as with many marital assets, the value of a privately held business under the control of a spouse might diminish in value as the divorce proceeding progresses.

Goodwill

The *International Glossary of Business Valuation Terms* defines goodwill as "that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified."[9] This goodwill can attach to the enterprise or to the working owner depending on the facts and circumstances regarding the relationships with the customers and other outside stakeholders.

Goodwill is an aspect of valuation that leads to many issues. The type of goodwill and how much should be included in the marital estate are issues that need to be addressed by the valuator. Undervaluing or overvaluing a business will inequitably shift value from one party to another.

Just like the standard of value, goodwill is handled by jurisdiction. Many states, including Pennsylvania, bifurcate goodwill between enterprise and personal goodwill. Enterprise goodwill is a divisible marital asset, and personal goodwill is not. Some states, including South Carolina, do not include any goodwill, which essentially results in the value of a closely-held business being equal to the net tangible asset value.

Enterprise goodwill is the goodwill that can be transferred upon the sale of a business. It is the goodwill that exists without the presence of the business owner's spouse.

[9] *International Glossary of Business Valuation Terms,* June 2001, as adopted by the American Institute of Certified Public Accountants, the American Society of Appraisers, the Canadian Institute of Chartered Business Valuators, the National Association of Certified Valuators and Analysts and the Institute of Business Appraisers

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Personal goodwill is the type of goodwill that attaches to the persona and the personal efforts of the individual. This type of goodwill is not easily transferred, if at all. There are many factors that are considered in determining the amount of personal goodwill including:[10]

- Age and health of the professional;
- Demonstrated earning power;
- Nature and duration of the professional's practice or business;
- Reputation of the professional in the community for judgement, skill and knowledge; and
- The professional's comparative success.

There are no empirical studies to provide benchmark percentages for allocating personal goodwill. Moreover, there are no formulaic approaches to assign value to either type of goodwill. There is, however, guidance in case law that has developed means to assist valuators to reasonably quantify personal and enterprise goodwill.

Double-Dip

A "double-dip" occurs when the same cash flow is used twice; once as an asset (i.e. the value of a spouse's equity interest in a business) for asset division purposes and, again, as income available for support. More specifically, a double dip occurs where the Court uses a business owner's excess earnings to value the business and also sets support based upon that same spouse's total income, inclusive of the excess earnings used to value the business.

In appropriate circumstances when it would be inequitable to disregard the double-dip, the Court can order an equitable division of the marital estate based on a value for the spouse's business interest according to recognized valuation methodologies which utilize "excess earnings" as part of the valuation analysis, with a corresponding calculation of that spouse's support obligations based on the fair market value of "reasonable compensation" of the business owner (as considered and determined as part of the valuation methodologies utilized).

While the concept of "double-dipping" in business valuation for divorce purposes is recognized and commonly accepted, the particular facts and circumstances of each case must be thoroughly analyzed in order to fully understand the potential inequities that may exist.

Final Thoughts on Marital Dissolution

Business valuation in the context of martial dissolution often presents a number of nuances and complexities, which are outside of the realm of a typical valuation. The valuator will rely on the guidance of legal counsel as well as judicial precedence in the jurisdiction where the divorce proceeding is taking place.

[10] *Lopez v Lopez,* 113Cal. Rptr. 58 (38 Cal. App. 3d 1044 (1974))

Special Purpose Valuations

V. Understanding the Nuances of ESOP Valuations

An Employee Stock Ownership Plan (ESOP) is a qualified retirement plan that is designed to invest primarily in the stock of the sponsoring organization. At its core, an ESOP is intended to not only provide its participants, the employees of the sponsoring organization, the benefit of ownership and value appreciation in their retirement accounts, but also to provide the sponsoring organization the benefit of a workforce whose goals are aligned with those of the operating entity.

While it is not the intention of this program to take a detailed look at the benefits of ESOPs or the mechanics behind the formation of an ESOP, please note that we have authored multiple publications regarding ESOPs in the past. For more information about ESOPs or access to our prior publications, visit www.gyf.com.

An ESOP can be a useful tool in corporate planning in that it accomplishes several tasks simultaneously. First, it provides owners of a privately held enterprise a liquidity event when they sell their ownership interest to the ESOP. Second, it provides employees a way to benefit from the growth in value of the sponsoring organization. Finally, it provides many tax incentives for the sponsoring organization as well as the selling shareholder(s).

In conjunction with the initial (as well as any subsequent) transaction(s) in which an owner in a sponsoring organization sells its ownership interest to an ESOP, the sponsoring organization will borrow funds necessary to purchase the ownership from the seller. This is usually a blend of bank and seller financing. If the ESOP owns at least 30% of the stock of the sponsoring organization immediately after the sale, and the seller reinvests the sale proceeds into securities of other domestic corporations, the seller can defer paying tax on the sale proceeds. Additionally, both the interest payments and the principal payments on the loan secured by the sponsoring organization can be taken as tax deductions. Dividends paid in cash on shares held by an ESOP are tax deductible by the sponsoring organization as long as they are passed through to the participants in the plan or if they are used to pay off a loan secured to purchase the stock from the selling shareholder. Finally, ESOPs qualify a shareholder in S Corporations, allowing the income that is passed through to the ESOP to avoid taxation as ordinary business income or unrelated business income, essentially making the income tax-free to the ESOP as a shareholder.

Valuation

Determining the value of an ESOP participant's retirement account is difficult. Unlike other qualified retirement plans, such as a traditional 401(k), which invest in publicly traded companies, a participant in an ESOP must rely on a valuator to appraise the sponsoring organization's stock price. Department of Labor regulations require that ESOPs be valued at least annually in order for plan Trustees to meet their fiduciary requirements.

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The valuator's appraisal is used by the trustee(s) in meeting that fiduciary obligation. As such, in a valuation engagement related to the determination of the value of an organization held by an ESOP, the trustee(s) of the ESOP will directly engage the valuator. Treasury Regulations note that the valuation should be performed by a person who customarily engages in the valuation of businesses and is independent with respect to the sponsoring organization as well as all parties to an ESOP transaction.

Valuing shares of corporate stock held in ESOPs presents many unique challenges to a valuator. As participants in an ESOP meet certain eligibility requirements and elect to diversify their retirement account portfolio or upon certain triggering events (termination of employment, death, disability, etc.), participants have the ability to put their shares of corporate stock back to the company. That is, the sponsoring organization is required to repurchase a participant's shares of stock under certain circumstances. This creates a market for a participant's shares of stock in the sponsoring organization that is not apparent in most privately held business enterprises. The presence of this market, must be considered in the valuation analysis.

Standard of Value and Premise of Value

The standard of value in an ESOP valuation is "adequate consideration" as that term is defined in the Department of Labor's ERISA regulations.[11] Adequate consideration is defined as the "fair market value" of the asset as determined in good faith by the fiduciaries. As previously discussed, fair market value is commonly accepted by various valuation credentialing organizations as well as strictly defined in the *International Glossary of Business Valuation Terms*. In accordance with the fair market value standard, ESOP valuations will be performed without consideration given to any buyer-specific motivations or synergies, which would shift the resulting standard of value from adequate consideration (or fair market value) to investment or strategic value.

As noted, operating companies will almost always be valued on a going concern basis. As it relates to ESOPs, most sponsoring organizations that elect to become ESOP-owned do so as a means to strengthen business succession and success going forward. With this goal in mind, it makes sense that the premise of value in ESOP valuations is generally going to be going concern, or valuation of the company in ongoing operations.

Date of Valuation

If a valuation is being performed in conjunction with an ESOP transaction (an owner selling all or part of their interest to an ESOP), the date of valuation used by the valuator will be the transaction date. This creates unique issues for the valuator due to the delayed nature of financial reporting. A valuator will generally perform

[11] Department of Labor regulation 3(18)(b) of the Employee Retirement Income Security Act of 1974

the analysis as of a date in time prior to the close of the transaction, and update the analysis as current information becomes available. A valuator is also commonly retained to provide a fairness opinion in conjunction with an ESOP transaction, which provides assurance that the transaction price is fair to the ESOP from a financial perspective. The fairness opinion will also be as of the date of the ESOP transaction.

Valuations performed in conjunction with the periodic determination of adequate consideration by the trustee(s) of the ESOP will utilize a date of valuation as dictated by the ESOP plan documents. As noted earlier, the Department of Labor requires that ESOP trustees determine the value (with the aid of a valuator) of the ESOP stock at least annually. If the trustee determines that the price should be determined on an annual basis, it is the experience of the authors that most ESOPs mandate that the valuation is performed with an "as of" date mirroring that of the sponsoring organization's fiscal year-end.

ESOPs holding ownership positions in larger enterprises may require valuations multiple times per year. The frequency of valuations is primarily a function of the number of participants in the plan. As the number of participants increases, the frequency in which participants will be putting their shares back to the company increases. Should the number of transactions reach the level to warrant multiple valuations per year, the trustee(s) will retain the services of a valuator accordingly.

Subject Interest and Discounts

In identifying the subject ownership interest, a valuator will commonly state that the purpose of the valuation is to determine the fair market value of the shares of common stock of the sponsoring organization held by the ESOP. In conjunction with the valuation of the subject interest, a valuator will consider the entire legal bundle of rights attributable to those shares held by the ESOP.

When considering the propriety of discounts related to the shares of the sponsoring organization's stock held in an ESOP, the bundle of rights and ownership characteristics associated with the block of stock will determine what discounts are applicable. One nuance related to ESOP valuations is the impact of marketability on the subject block of stock. Consideration of a discount for lack of marketability hinges on the ability or inability of the holder of the interest to quickly liquidate the interest or convert his or her investment to cash. Under ERISA, an ESOP provides a "put right", which requires the sponsoring organization to purchase the participant's stock under specific circumstances. This put right creates a market for the stock unique to ESOPs. As a result, discounts for lack of marketability applicable to ESOP shares are generally much smaller in magnitude than discounts applicable to privately held enterprises. The DOL has increased its focus on the level of discounts applied by valuators for lack of marketability. Where marketability discounts applicable to a fractional ownership interest in a privately held enterprise generally exceed 20%, it is the experience of the authors that discounts for ESOP related ownership interest are generally less than 10%.

Other Considerations

Resulting from the put right associated with participants' shares in an ESOP, the sponsoring organization is left with a repurchase obligation that is not recorded on their financial statements. In short, the repurchase obligation is the present value of the cash outlays for future share repurchases of ESOP stock. A sponsoring organization can engage a firm specializing in repurchase obligations to forecast the future obligations so that the sponsoring organization can appropriately plan to meet the cash needs resulting from the future share transactions. While management of the obligation falls upon the trustee(s) and management of the sponsoring organization, the valuator must consider the magnitude of the obligation and the organization's financial ability to meet the future needs.

Often ESOP transactions involve the implementation of synthetic equity instruments or plans, which must be considered in the determination of the share price. If a transaction involves seller financing, transactional trustees commonly include seller warrants as part of the transaction. Seller warrants are similar to an option, they will have a stated exercise price and date, with the former usually set equal to the sponsoring organization's stock price immediately after an ESOP transaction, and the latter aligning with the payoff of the seller note. Warrants allow a seller to recognize additional benefit through the appreciation of the sponsoring organization's stock price over the duration of the seller note. Warrants are used by trustees to assure the seller note provides the holder with a fair rate of return. In practice, the warrants represent a future cash outflow to the sponsoring organization. This cash outflow must be considered by management of the sponsoring organization and the valuator.

An additional tool available to reward management of ESOP sponsor organizations is a stock appreciation rights (SARs) plan. SARs plans, in general, provide additional compensation to management for the appreciation in the sponsoring organization's share price over a specific period of time. Unlike the value of a participant's account balance, which can only be diversified or liquidated under specific triggering events, the benefit of a SARs plan is paid in a much shorter period. The existence of a SARs plan also creates a future cash outflow for the sponsoring organization. These plans require the valuator to assist management in forecasting and quantifying the future cash outflows based upon expected growth in share price, and include the impact of the cash payments in the discounted future cash flow analysis.

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In addition to guidance provided by the IRS and DOL in conjunction with the adequate consideration and fair market value standards of value, the DOL has entered into multiple "Settlement Agreements" specifically related to valuations in the ESOP arena. Settlement agreements are agreements between the DOL and ESOP trustees which direct the trustee as to what he or she must consider in his or her representation of ESOPs going forward. While settlement agreements do not set a legal precedent, they do provide insight into the position of the DOL on specific nuances related to ESOPs and the valuation of the shares held therein. The settlement agreements primarily relate to allegations by the DOL that trustees caused the ESOP to purchase shares from a selling shareholder of a sponsoring organization at a price above adequate consideration (fair market value), harming the ESOP and its (eventual) participants.

The first, and arguably most significant, settlement agreement entered into by the DOL was in 2014 with GreatBanc Trust Company, an institutional trustee. This settlement agreement laid the groundwork for a number of settlement agreements that followed. To date, the DOL has entered into five settlement agreements with institutional and individual trustees. In summary, the GreatBanc process agreement requires GreatBanc to investigate a valuator's qualifications, assess whether the amount of information the valuator received is sufficient to provide an opinion of value, document the valuator selection process, oversee the process and analyses undertaken by the valuator, and review the final opinion of the valuator. While each of the settlement agreements specifically pertains to the trustee(s) involved, many valuators use the requirements therein as a guide in performing their own valuations to ensure that the possibility of DOL scrutiny is minimized.

Conclusion

Valuations performed in conjunction with ESOPs require specialized knowledge of the nuances these plans create when determining share price. Failure to understand the unique aspects related to ESOPs will create potential exposure for the valuator and for the trustee(s) of the ESOP. When implemented properly, and with assistance from the proper experts, ESOPs provide significant tax benefits to the parties involved and support the prosperity of the operating company.

VI. Understanding the Nuances of Accounting-Based Valuations

Valuations performed for financial accounting purposes are typically in the area of reporting of a business combination or subsequent impairment testing in accordance with generally accepted accounting principles. The Financial Accounting Standards Board (FASB) implemented fair value accounting for business combinations issuing standards in 2001. These standards were subsequently revised and reclassified as Accounting Standards Codification (ASC) 820, *Fair Value Measurement*, ASC 805, *Business Combinations,* and ASC 350, *Intangibles.* The International Accounting Standards Board (IASB) issued IFRS 13, *Fair Value Measurement* to provide equivalent (nearly identical) fair value standards as the United States.

Most of the work performed by valuation professionals in this area involves the valuation of intangible assets acquired in connection with a transaction and subsequent impairment of the same assets. Valuations are also performed to measure share-based compensation. The authors of this material have published materials on this topic, which can be downloaded from our website at www.gyf.com/resources/documents. As such, the balance of this chapter will focus on valuations for business combinations and impairment.

Types of Assets Valued

ASC 805, *Business Combinations* (formerly Statement on Financial Accounting Standard No. 141), sets out categories of intangible assets that are required, under the literature, to be recognized on the business's balance sheet, separate and apart from goodwill. Generally, valuation analysts and other financial professionals group individual intangible assets into several common categories. Intangible assets in each category are typically similar in nature, function and methods for valuing the assets. For purposes of this material, we provide the following five major categories of intangible assets.

1. ***Marketing-related intangible assets*** – are those assets primarily used in the marketing or promotion of products or services. Examples are trademarks or trade names, newspaper mastheads, internet domain names and noncompetition agreements. The aforementioned assets enhance the value of a business by supporting its marketing activities and by creating or preserving a competitive advantage.

2. ***Customer-related intangible assets*** – occur as a result of interactions with outside parties. Examples are customer lists, order or production backlogs, and contractual and non-contractual customer relationships. Often customer relationships consist of both a contractual component and an additional relationship component. The value derived from a contract is evident. The value of the relationship component results from the possibility that the contract will be renewed, thereby preserving the relationship and providing future cash flow.

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3. ***Artistic-related intangible assets*** – involve ownership rights to plays, literary works, musical works, pictures, photographs, and video and audio-visual material. These ownership rights are protected by copyrights. Artistic intangible assets can be recognized individually or in conjunction with related (or similar) assets.

4. ***Contract-related intangible assets*** – represent the value of rights that arise from contractual arrangements. Examples are franchise and licensing agreements, construction permits, broadcast rights, and service or supply contracts. A common form of a contract-related intangible asset is a franchise.

5. ***Technology-related intangible assets*** – are associated with innovations or technological advances. Examples are patented technology and trade secrets.

Standard of Value

The standard of value used in connection with accounting-based valuation is fair value. In accordance with FASB ASC 820, *Fair Value Measurement and Disclosures*, "fair value" is defined as:

"the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[12]

ASC 820 discusses fair value measurements at length and sets forth the following interpretive components:

- An orderly transaction is one that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual or customary for transactions involving such assets or liabilities; it is not a forced transaction.
- A fair value measurement assumes that the transaction occurs in the principal market for the asset or, in the absence of a principal market, the most-advantageous market for the asset.
- The price in the principal (or most-advantageous) market used to measure the fair value of the asset should not be adjusted for transaction costs.
- Market participants are buyers and sellers in the principal (or most-advantageous) market for the asset that are:
  - Independent of the reporting entity; that is, they are not related parties.
  - Knowledgeable, having a reasonable understanding about the asset and the transaction based upon all available information, including information that might be obtained through due diligence efforts that are usual and customary.

[12] FASB Fair Value Measurement (Topic 820), No. 2018-30, August 2018, https://asc.fasb.org/imageRoot/81/118196181.pdf

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   - Able to transact for the asset.
   - Willing to transact for the asset; that is, they are motivated but not forced or otherwise compelled to do so.

- The fair value of the asset should be determined based upon the assumptions that market participants would use in pricing the asset.
- A fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date.
- The highest and best use of the asset establishes the valuation premise used to measure its fair value.
   - ***In-use:*** The highest and best use of the asset is *in-use* if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use).
   - ***In-exchange:*** The highest and best use of the asset is *in-exchange* if the asset would provide maximum value to market participants principally on a standalone basis.
- The highest and best use of the asset is determined based upon its use by market participants. As such, the fair value measurement considers the assumptions that market participants would use in pricing the asset, whether using an in-use or an in-exchange valuation premise.

A final key consideration contemplated in the definition of fair value is the distinction between transaction price at the date of asset acquisition versus exit price at the date of the asset's disposition. Though these two prices may be equal, at least conceptually, the prices are different. The fair value of an asset represents the price that would be received if the asset were sold, i.e., the exit price.

Premise of Value

The assessment of the highest and best use, as noted above, determine which of the four alternative, fundamental premises of value should be applied. The premises include:

1. Value in continued use as part of a going-concern enterprise
2. Value in place, but not in current use in the production of income
3. Value is exchange, as part of an orderly disposition
4. Value in exchange, as part of a forced liquidation

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The valuator selects the appropriate premise of value based upon the following:

- The purpose and objective of the valuation;
- The functional and economic status of the subject intangible asset; and
- The highest and best use of the subject intangible asset.

Valuation Date

The date of valuation with respect to a business combination is typically the date the transaction occurs. Impairment analysis should be completed at least annually. In the event that impairment is expected, the date of valuation should be as of that date.

Valuation Methodologies

The three general approaches to valuation remain the same when preparing valuations for financial accounting purposes; however the methods thereunder in this type of valuation have many nuances. The fair value standards require the use of "valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs". Observable inputs are derived from market participants, and unobservable inputs are based on the entity's own assumptions.

The cost approach is used for these purposes more often than in valutions for other purposes. The cost to recreate an asset is often used to value software, an assembled workforce and other technology purchased in a business combination.

The income approach associated with the fair value of intangible assets includes the use of a multi-period excess earnings calculation. This calculation is similar to a discounted future cash flow model, but includes consideration of economic charges for other assets (including other intangible assets) in support of the subject asset.

The market approach uses prices of market transactions involving identical or similar assets. This approach is the most difficult to apply in this context, as some companies are reluctant to sell while others that do sell intangible assets are not usually made public for competitive reasons.

Under any method used to determine the fair value an intangible asset or financial accounting purposes, consideration should be given to calculating the present value of benefit of recognizing amortization expense. Additionally, in conjunction with valuing an intangible asset or group of assets, the remaining useful life of the asset(s) must be determined.

Special Purpose Valuations

Conclusion

Performing valuations for financial accounting/reporting purposes is a specialized area of valuation. This is due to the nuances of determining the value of an intangible asset or group of assets when compared to valuing an entire business or equity interest therein. The standard of value is not quite the same as fair market value; the valuation methodologies are specific to this type of valuation; market participant assumptions are used; and, there are a number of other aspects that set financial accounting based valuations apart from valuations performed for the other purposes presented in this material.

VII. Concluding Thoughts

As discussed, the conceptual idea of value and the resulting determination of that value is heavily influenced by the purpose for which the business valuation is undertaken. Thus, it is incumbent upon the reader/user of any business valuation report to fully understand why the business valuation was prepared and what the original purpose was for requesting that particular assessment of value.

In any well-prepared business valuation report, the authors will note that the resulting determination of value is limited to the purpose of the assignment as set forth therein. Moreover, most reports will also note that the conclusion of value included in that report is to be used only for that purpose. This limitation is included under best practices and business valuation professional standards of practice. It is a reasonable and sensible disclosure, as a failure to respect the purpose of the business valuation could easily lead to an error in interpretation as to the meaning of concluded value.

The limitation eliminates the usefulness of the conclusion of value for any purpose beyond that specified in the report. The question, then, in a legal setting, is whether there is any significance of a valuation determination prepared under professional standards of practice for a purpose other than that currently required by counsel in a current matter. This is a question that cannot easily be answered.

First, in conjunction with this "purpose" limitation, there is a date limitation. All business valuations are developed as of a certain point in time since any measurement of value of an equity interest can change from one date of measurement to the next. Second, seldom is there sufficient information included in a business valuation report (nor is there required to be) that would enable a later absolute reconciliation of the factual and procedural nuances considered in the earlier assignment to meet the current needs of any alternative purpose. However, there are fundamental procedures and protocols that may allow for some level of reconciliation depending on the facts and circumstances. The determination of the usefulness of such reconciliations lies with legal counsel.

By way of example, one might have had a business valuation completed for the purpose of estate and gift tax planning to develop a lifetime gifting strategy, whereby the equity of the business is intended to be transferred to junior generation family members. As discussed, such a purpose would require a determination of fair market value. Generally, this financial value would consider all hypothetical buyers, and focus on the Company as it is currently structured and expected to continue. Assume, later, that a minority equity holder in the business decided to depart, and that value is not well defined in the equity holder buy/sell agreement. As a result of the agreement's failure to adequately define the standard of value, the need for a business valuation arises to address the matter to both parties' satisfaction, if possible.

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In a such a case, a business valuator would look for legal counsel to set the standard of value. Very often, legal representatives will jointly stipulate to the "kind of value" they need at the future date of valuation in guiding the business valuators. If the stipulation is to use the same standard as in the earlier report prepared for the purpose of estate and gift tax planning, there is, of course, a better opportunity to bring that value forward to the later date of valuation required in the current proceeding, even though the purpose is very different. The process would require an analytical assessment of all of the content in the earlier report and replication of the earlier procedures so long as the current valuators agreed with the earlier assumptions, procedures and protocols.

Unfortunately, in fact patterns such as those noted above, it is unlikely that the departing equity holder would be satisfied with the earlier valuation mechanics, as that purpose will have likely generated a more conservative value due to the imposition of federal and state property transfer taxes. Thus, there will probably be a need in such assignments to attempt an understanding of all underlying elements of the earlier report if counsel wished to consider its reliability and relevancy in his or her current case.

Another example of the difficulty in assessing whether a valuation prepared for one purpose can be useful in considering value for another purpose might be using the valuation report prepared earlier for estate and gift tax planning, and utilizing the value determination as a proxy for value in undertaking a feasibility study to adopt an employee stock ownership plan. In both cases, the standard of value is fair market value subject to the exact same definition. However, as discussed earlier, an ESOP requires substantial consideration of any underlying projections of future expected economic benefits and carries with it a heavy emphasis on protecting the employee participants who will be effectively purchasing the company's shares, if such a plan were adopted. With respect to the current shareholder(s), the ESOP strategy invokes a substantially different motivation than the prior estate and gift tax planning business valuation. While the primary incentive in the estate planning valuation was to lean towards a conservative result, a sale of their shares to an ESOP drives the sellers to focus on a more aggressive valuation. Thus, depending on the key elements of the earlier report, if they can be fully determined, the earlier valuation purpose may or may not have any relevancy to the current needs in facilitating current strategies.

It is noteworthy that even though reconciliation of a determination of value prepared for one purpose with a different purpose later on can prove exceedingly difficult, it is not uncommon for courts and/or opposing counsel, to consider earlier (and sometimes later) valuation reports with differing purposes. There have been instances in which the Internal Revenue Service has looked to post-date-of-valuation sales of equity interests and inferred modifications upward to earlier value determinations prepared for estate and gift tax planning purposes. This has been done, even though the standards of value driven by the differing purposes conflict. In

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such cases, the need arises for the valuation expert to differentiate the two determinations of value and explain to the parties, or the court, why the earlier-prepared report is (or is not) useful to the determination of value for the matter at hand.

Attorneys should be familiar with nuances of any value determinations brought about as a result of the purpose of the engagement. In any case, the authors stand ready to assist with these assessments as to whether prior business valuations carry any meaningful indications of value in current matters being considered for strategy development or impact on controversy matters.

In any case, all prior valuations should be reviewed in conjunction with preparing a new valuation, whether that project is being prepared as an update to the earlier work with the same purpose, or whether the purpose is unrelated. Best practices and professional standards dictate that valuators request all prior valuation reports as part of their document request procedures. The authors request such prior reports on every engagement.

It is, as always, our expectation that after attending our Continuing Legal Education programs, you are provided with some information that might useful in the conduct of your practice as you return to your office today. We hope that you have found the program fulfilling in that respect, and that your time spent with us was beneficial. We do understand that each of you is exceedingly busy and we appreciate your attendance today.

We also appreciate deeply the kindness the legal community has shown us in bringing opportunities to our firm, and our group. It is our great pleasure to work with you and we look forward to working together in the future. Thank you for attending and have a great day!