Spring 2012 Newsletter

Are You Properly Using Promissory Notes in Connection with a Buy-Sell ?

A buy-sell agreement often gives the Company the right to pay for stock acquired from a departing shareholder with, in part, a promissory note. Typically, the note's stated interest would be equal to the Prime rate, quarterly repayments of principal and interest would be required, no prepayment penalty, and a final maturity of 5 years. Generally, this provides flexibility to the Company, which is advantageous, indirectly, for all concerned. But is this really a fair exchange between this and the stock ? Is it fair to the seller ?

Given that the note, again typically, includes no covenant which would protect its holder should the Company become heavily indebted, no secondary collateral position, no third-party guarantee and other protections, the value of the note would appear to be less than its stated value, i.e. the seller is not getting the value bargained for. In fact, if the regular borrowing cost of the Company under its secured bank line is prime plus 2% and the difference in creditworthiness between the note and the bank line, for argument's sake, amounts to another 2% spread, then the note should be valued using an internal rate of return of 10% [6% prime + 2% +2%.] Accordingly, the present value of the note can be calculated using as inputs the 10% rate, the same required quarterly dollar payments, 20 quarters and no future value. The present value is equal in this fairly typical case to approximately 90.8% of the value agreed upon for the stock. Put another way, the seller is receiving his price for the stock less an approximately 7.2% discount after considering the down payment. Business litigation, anyone ?

Estate of Giustina : Will the IRS use this as a Precedent ?

<u>Estate of Natale B. Giustina, Deceased v. Commissioner</u> T.C. Memo 2011-141 filed June 22, 2011.

Through a trust, the Decedent owned a 41.128% limited partner interest in Giustina Land & Timber Co. LP ["the Partnership."] The Partnership itself was one of several entities resulting from a split between Giustina family members in 1990. In 1994, a buy-sell agreement barred limited partners from selling their interests except to other partners in the same interest group, i.e. descendants of the same branch of the family. Limited partners can remove the GP's authority to manage the business if 2/3 of the interests agree. In 2002, both general partners resigned and were replaced by LLCs they controlled. As of the Decedent's date of death in 2005, the 2 LLCs each had a general partnership interest of 1%, the Decedent [as trustee] had a 41.128%

limited interest, 2 other relatives had limited interests in the 16-17% range each, and 5 other relatives each had 4-5% limited interests. The partnership owned 47,939 acres of timberlands. It had 12-15 employees and while the LLCs were nominally the General Partners, their owners actually ran operations. The estate and the Service valued the interest at widely divergent levels.

As common in timber interest valuations, two commonly used methods can be used here; the Cash Flow method, which estimates the future benefits of cutting and selling logs as per present policy, contrasted with the Market method, which after applying a 40% discount to reflect a lengthy time-to-sell, assumes that all property is sold.

While the DCF method is clearly capable of estimating the present value of future returns, the Court criticized the estate's reduction of estimated first year cash flow for income taxes [the discount rate was pre-tax.] Further, the discount rate used by the estate was reduced from 18% to 16.25% based primarily on the Court's rejection of a partnership-specific risk premium of 3.5%. Other components of the discount rate, including a 50% beta, were accepted by the Court as per the estate's expert report. At that point, the value is $33.8 million [estate] versus $51.7 million [Service.]

The Court did not believe the estate's 35% lack-of-marketability discount, preferring the Service's 25% because the Service's argument was not rebutted by the estate. Finally, the Court assigned a 75% weight to the DCF result because that was its opinion of the probability of the partnership continuing based on its existing business model.

The value of selling all assets, even after a large discount for illiquidity, was $143 million. The Court stated that, in that eventuality [25% probability] a discount for Lack-of-Control is inappropriate, having been already factored by the above probability. Also, no Lack-of-Marketability discount was likewise allowed in this eventuality, as this would amount to double-counting. The Court also rejected a distribution-only capitalization and a guideline public-company analysis as inappropriate to value a private firm cutting and selling logs. The Court also rejected the Service's call for a §6662 penalty. The estate, in the end, obtained a reasonable tax value.

It is always possible, as many have commented, that this win by the Service will be applied to valuing non-timber investments in the future, i.e. the low discounts could be used without the probabilities and result in an injustice to the taxpayers. This would be an error, since few industries, including real estate, exhibit such a disparity between selling value and "earning" value as timberlands.

SV Investment Partners v. Thoughtworks, Inc.

This Delaware Chancery Court case revolves around the valuation for redemption purpose of preferred stock in an information technology firm. The decision was filed September 8, 2010. Redemption of the preferred was permissible under existing agreements, "for cash out of any funds legally available," and the company was required to value its assets "at the highest amount permissible under applicable law."

The preferred shareholders, which had invested $27 million in the preferred, assumed that the first expression, which can be commonly found in stock redemption agreements, meant funds which carry no legal prohibition of use; for example, capital surplus generally is not restricted. The shareholders submitted a going-concern valuation of the business exhibiting a range of value between $68 and $137 million.

The Court disagreed, noting that funds legally available is not synonymous with surplus. Distributions, the Court explained, are never paid out of surplus, but from cashing out assets including cash balances. Instead, the phrase contemplates funds that are readily accessible/available and do not violate statutory or common law restrictions against a redemption that would render the company insolvent. The Court found that these basic principles did not clash with the above wording. Correspondingly, the wording did not create an obligation to redeem when no funds exist, nor did they trump other legal impediments to the use of funds, such as a resulting insolvency. The valuation presented to the Court, the latter concluded, failed to consider the "real economic value of the company's assets" which it could use for redemption while continuing as a going concern. The plaintiffs' suit was thus denied. The decision is at http://courts.state.de.us then click on Opinions, then on Court of Chancery. Change the year to 2010 and search for SV Investment.

IRS Lists 7 Mistakes of Highly Unsuccessful Appraisals

Appropriate Discounts: Are they supported by evidence ?
Standard of Value: FMV is the required standard involving tax valuations, but many appraisals are still based upon the fair value standard, or consider the perspective of only one person rather than both buyer and seller.
Tax Effecting: Neither the Courts, the Service or many appraisers have been fully consistent in valuing S corporations. Facts and circumstances, of course, are the key.
Factual Errors: All facts should be checked.
Valuation Errors.
Analytical Errors.
Documentation Issues.

Lost Profit Calculations in the Courts

In R&R International v. Manzen, the defendant breached a distribution agreement afer only 5 months and the plaintiff claimed damages of $8 million. The Court accepted the investment banking background of the expert, but balked at his report being largely downloaded from Wikipedia and other unidentified sources. The basis for his sales and distribution cost estimates was not stated, and he had compared this distributor of beverages with large beverage manufacturers. The Court struck the report down. [Southern District of Florida U.S. District Court, opinion issued September 12, 2010.]

In Ho Myong Moolsan Co., Ltd v. Manitou Mineral Water [U.S. District Court for the Southern District of New York] the plaintiff's claim for breach of a distribution agreement was dismissed on *Daubert* grounds. The reason is that the expert's conclusion was found to be unreliable. The District Court agreed, stating that because his report did not require or evidence any special knowledge, and did not support the anticipated revenue growth in any way, the report was rightly excluded. The case reference is 1:07-CV-07483-RJH-HBP.

New Forms Issued by the IRS in connection with IRC 6039 require a Valuation

The Service has published 2 new forms, along with instructions. Form 3921 is required to be filed when an employee or former employee exercises an Incentive Stock Option. Form 3922 is required when a corporation records a transfer of legal title of share acquired under an employee stock purchase plan. The latter is required even if a broker or third party is the acquirer and either (a) the purchase price is less than the fair market value of the shares on the day of grant or (b) the purchase price was not fixed or determinable on the day of the grant.

The forms are available at http://www.irs.gov/pub/irs-pdf/f3921.pdf or f3922. The instructions are at http://www.irs.gov/pub/irs-pdf/i3921.pdf. For privately-held issuers, it would make sense for management to not only file the appropriate forms but also discuss the fair market value of the shares with the employees concerned.

J.L. Pierson, ASA is an experienced business appraiser covering the tri-state area from his base in Darien, CT. His clients are closely-held businesses with revenues of up to $250 million, as well as owners of family limited partnerships and professional corporations. He specializes in business valuation for estate/gift tax, succession planning, and litigation such as shareholder disputes and divorce, corporate development and other transactional support purposes.

J.L. PIERSON, ASA
P.O. Box 2392
Darien, CT 06820-0392

http://www.NYNJCT-BV.COM
(203) 325-2703

Change Service Requested