Fall, 2011 Newsletter

Well-Written Shareholder Agreements Avoid Costly Litigation

A shareholder or buy-back agreement is an understanding between shareholders and a corporation, under the law, about various aspects ranging from the shareholder duties to rights, in relation to the corporation. The agreement laws down the guidelines about the duties and powers of the board of directors and the management.

Three Shareholders and Friends

A, B and C were close friends who graduated from XYZ University together; all were engineers by training and business background. After years working for others, they saw an opportunity when a business became available and they bought it. The three became shareholders in the business, and they all agreed that a simple shareholder agreement would be best. Without the help of an attorney, they drafted and signed an agreement to the effect that the corporation would buy any terminating or deceased shareholder's stock at book value.

A and B worked hard to develop the business, while C was considerably less commited. Over time, the business grew beyond expectations. Perhaps the partners were counting on their respective close ages to avoid trouble, but this was not to be so.

What Happened Next

C died suddenly, well before his normal life expectancy. Under the terms of the buy-out agreement, the remaining partners were soon delivering a check for one third of the corporation's book value to C's widow, say $400,000.

Soon thereafter, the company was sold to a strategic buyer for $15 million, which was split between the remaining shareholders. With equal predictability, the widow sued A and B for her share, less the pay-out already received. The jury considered that the buy-sell agreement did indicate that deceased shareholders were to receive the pro rata share of book value; they also considered the fact that C was not a clear contributor to the corporation's revenues earnings, and the jury decided that C's widow was only entitled to a third of book value.

The agreement was clearly deficient, placing the jury in a position where it had few choices but it eventual decision. The agreement should have been clear to the effect that the value used in redeeming departing shareholders was to be the fair market value at the time. It should have made clear that, if the company is sold within, say, a year from separation/death, the price obtained is the fair market value. The agreement was not even clear on the date of determination of the book value. It was not even clear as to whether the book value as per tax returns or books would be used. Finally, it did not indicate whether a minority discount would be applied to the departing shareholder's stock, or whether the pro-rata share would be used. The result was most unsatisfactory to C's widow, but nothing could be done at that point.

At a minimum, the following should have been considered by the 3 shareholders and incorporated in the agreement.

1. Valuation Date: Is the valuation date the date of termination, date of death [as may be required for estate tax valuation,] or the date of the last fiscal year end ?

2. Value Standard: book value [as may be very relevant for companies with a high concentration of liquid receivables and inventories compared to, say, fixed assets;] adjusted net asset value [FMV of all assets, including intangibles such as goodwill, patents and copyrights] or FMV based on the economic earnings of the business [e.g. DCF;] or the ratio of selling prices to revenues of similar companies [market-based method] ?
3. Discounts: will minority and lack-of-marketability discounts apply, or will the stock be redeemed at pro-rata share of the company value discussed above ?
4. Annual valuations: Will the stock be valued on an annual basis so that changing economics are considered on a somewhat timely manner ?
5. Appraisers: will a competent business appraiser be engaged to value the stock, much like for IRS required estate valuations ? or will the value be negotiated by the remaining shareholders <sic> ?
6. Life insurance: will the purchase of the stock be funded by life insurance ?
7. Un-wanted owners: does the agreement stipulate that the departing or deceased shareholder can/can not sell his/her shares to anyone other than the remaining shareholders ?

It is a good idea to periodically review, and change if need be, your business's buy-sell agreement.

Estate of Louise Gallagher, deceased v. Commissioner,
T.C. Memo 2011-148 filed June 28, 2011

At issue is a the value of a 15% non-marketable minority interest in a Kentucky LLC which had elected to be taxed as an S corporation. The entity's principal assets were various newspapers, specialty magazines and a TV station operating in small markets. The case represents, on balance, a victory for the estate as the Court determined value [$32.6 million] much closer to the latter's litigation value of $28.2 million than the IRS' revised litigation value of $40 million. However, both experts ran afoul of Judge Halpern, at times because the Judge's position was barely more supported than the positions of the experts he disagreed with.

The Service and the Estate disagreed about almost every aspect of the valuation such as the date of the relevant financial information to be used, the normalization adjustments, the propriety of relying on a market-based approach through the value of public guideline companies, the specific application of the DCF method, the appropriate adjustments to enterprise value and the nature and size of the valuation discounts.

The decedent died on July 5, 2004. The Court reasonably decided that it was appropriate to use end of June financial information for both the Company and the public guideline companies. The Estate's appraiser has used end of May and end of March data, respectively, in an overreaching effort to use only what was known on the Valuation Date. All normalization adjustments of the Estate's appraiser were rejected because the latter did not explain them; some did sound quite plausible. Only the IRS appraiser used the public guideline company method, but the Court disagreed that it should be applied at all, since it only found one public firm, though larger than the subject, which was sufficiently comparable based on its own criterion. Projections used by a 3rd party lender in preparing a debt memorandum - the most sensible set of projections to use - were disregarded by both appraisers and the Court. Accordingly, both appraisers and the Court actually reconstructed their own set of projections based on respective judgement calls on likely future results. The theoretical basis of doing so is very thin, indeed.

Finally, the Court refused to tax-effect results in spite of there being several available models since *Gross* [T.C. 1999-254] which calculate the benefits of the S election [in fairness, none of the experts has used such models.] The reason given by the Court is that the estate's appraiser did not consistently use one tax rate. This opinion thus conflicts with common sense [who would buy equity which, in effect, belongs to the tax authority ?] and thus may very well be revisited by the 11th Circuit Court of Appeals. Further inconsistencies noted by the Court: the estate's appraiser [who did not use the public guideline method] was chastised for using the industry's percentage of equity versus debt in the calculation of Weighted Average Cost of Capital. The Court still does not like using WACC methodology "for a relatively small company," but in the end used it because both appraisers had. Another phobia is the CAPM, which the Court simply refused to sanction despite common use by practitioners.

Finally, despite admitting that his DCF approach produced a minority value, the Service's appraiser took a 17% lack-of-control discount which the Court proceeded to approve and increase to 23%, while criticizing the approach as simplistic [the expert had used the inverse of the control premium data published by Mergerstat.] Finally, both appraisers determined the LOMD at 30% based on a benchmark analysis; faced with rare consistency across parties, the Court agreed but criticized the theory used without going into details.

While it does not sound like the experts were using the latest in their tool boxes, the Court's refusal to use common techniques well past the acceptance stage is disturbing.

The Court decision can be found at http://www.ustaxcourt.gov. Click on Opinions Search, then enter "Gallagher." The file's name is GallagherEst.TCM.WPD.pdf. The decision is also available at http://www.NYNJCT-BV.com/GallagherEst.TCM.WPD.pdf. Please do not hesitate to call or e-mail to discuss this or any other business valuation issue.

The 9th Circuit of Appeals accepts Formula Clauses, joining the 5th and 8th.

In Estate of Ann Y. Petter et al. v. Commissioner [No. 10-71854] the Court affirmed the U.S. Tax Court's determination that "formula clauses" in estate documents did not necessarily involve sinister motives. The decision was filed August 4, 2011.The taxpayer had created Petter Family LLC and transferred $22.6 million of public company stock in exchange for membership units in the family LLC. Two trusts were then created, each for the benefit of each of her 2 children. As part of her estate plan, she transferred membership units as a gift and by sale to the trusts, with simultaneous gifts to 2 charities. The transfer documents included a dollar formula clause, which assigned to the trusts a number of units worth a specified dollar value, with the remainder of the units assigned to the charities. The documents also included a reallocation clause, which obligates the trust to transfer additional units to the charities if the value of the units initially received by the trusts is finally determined for federal gift purposes to exceed the specified dollar amount. This represents a victory for taxpayers, as formula clauses are an important, and now legitimate estate planning tool. The decision can be found at http://www.ca9.uscourts.gov/opinions/index.php then click on Advanced Search, enter Petter and download the file 10-71854.pdf. A copy is located at http://www.NYNJCT-BV.com/10-71854.pdf.

WISC Supreme Ct. calls "mistaken" the assumption that all personal Goodwill is un-divisible

In McReath v. McReath the Supreme Court of Wisconsin affirmed the Court of Appeals' determination that sellable, personal goodwill in a professional practice can be divisible marital property; it also approved of the lower court's property division and maintenance awards which followed the same line. This case may have a profound effect on marital distributions in states which appear to follow "the majority rule" to the effect that personal goodwill is assumed to be non-sellable and thus legally not part of the marital estate. In other words, the Court warned of widespread classification errors with respect to professional goodwill and termed "mistaken" the assumption that corporate goodwill is sellable and personal goodwill is not.

After obtaining an advanced dental degree, the husband worked for a multi-location orthodontics clinic. He then proceeded to purchase 2 of its locations for close to $1 million. He testified that approximately $100,000 of the price represented the value of physical assets, and that the balance, for the most part, was the value of the selling dentist's name, a non-compete agreement with that selling dentist, and latter's agreement to introduce his patients to the new owner and provide business advisory services for a period of years.

The new practice grossed an average of $1.2-1.8 million per year after the sale, and an annual cash flow of $700,000 accrued to the new owner, perhaps due to a lack of competing services in the area. While the new dentist did support his investment by working an unusually high numbers of hours per week for the first several years, he then reduced his hours to a more typical work load.

The husband's valuer used only the worse annual performance of the practice to reach, in a rather disingenuous fashion, a value of $0.4 million, which was rejected as biased and worthless by both courts. Clearly the "made to order" appraisal did not help the husband's case; his legal argument was that the "majority rule" does not allow personal goodwill to be included in the divisible value. The wife's appraiser had returned a value of $1 million, which the Courts accepted. Given that the personal goodwill - through a relatively common client introduction method by the selling professional - had been in effect monetized goodwill, it followed that it was divisible.

Many jurisdictions, including Connecticut, segregate professional goodwill into corporate, often assumed to be sellable, and personal goodwill which is likewise assumed to be un-sellable and thus not part of the marital estate. What the Wisconsin courts have stated is that, in effect, courts should scrutinize what part of goodwill is sellable and which part is not. The decision is available at http://www.NYNJCT-BV.com/McReathWIsupr.pdf .

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