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Bullet-proofing a Buy-Sell: Problem Areas to Address Before Signing the Agreement

Many parties negotiate a buy-sell agreement under the assumption that the "other guy will go first." Whether naïve or optimistic, the premise can prove true for only one of them, and a triggering event such as death, divorce, shareholder dissent, or other departure can expose parties to a buy-sell agreement to a multiplicity of problems.

A better tactic would be to identify the concerns of the parties at the outset while their interests are still aligned. Even better would be to engage a valuation appraiser during the negotiation of the buy-sell to propose "up-front" solutions to the problems that are likely to arise and to ensure that the agreement addresses both the amount and liquidity of the transferred shares. Although some clients may balk at the additional professional fees, these are minimal compared with the expensive—and extensive—litigation that can ensue from a poorly drafted or incomplete buy-sell agreement.

Most common pitfalls

Often, it's less important how clients resolve certain valuation issues, as long as their buy-sell agreements are clear and unambiguous and reflect the parties' intent. A business appraiser can help resolve the "how," while the following checklist will help the parties as well as their attorneys and accountants identify the most troubling issues associated with buy-sell agreements:

- *Standard of value.* A buy-sell agreement must clearly specify the standard of value. Some agreements simply mention "the value" of the company or interest: Does this mean fair market value, fair value, or some other standard? Each of these terms denotes a significantly different interpretation. If the agreement is not clear, the parties will have to try to agree on a standard of value upon a triggering event, long after their interests have diverged.
- *Book value.* One of the biggest problems is using the book value standard, as this often does not compensate the withdrawing or deceased shareholder for the value of intangible assets, for example, or contingent liabilities not reflected on the balance sheet. An inference that the book value of the shares equals their fair market value may depend on unwarranted or unreasonable assumptions, which may not account for changed conditions from the negotiation of the buy-sell to its triggering event.
- *Goodwill.* The agreement should also specifically address whether goodwill stays with the remaining shareholders.
- *Level of value.* Values can range from a controlling interest in a company to a nonvoting or nonmarketable minority interest to an illiquid, minority interest. Different assumptions apply to each level, such as the application of discounts or control premiums. If possible, buy-sell provisions should clearly identify which, if any, discounts and/or premiums apply.
- *Valuation date.* The "as of" date clearly identifies when the appraiser should value the interest and grounds the appraisal in such relevant and time-sensitive factors as the company's financial performance, the local and national economic conditions, etc.. The "as of" date could be the triggering event, the last fiscal year, an annual ESOP appraisal, or some other date or event.
- *Appraisal/arbitration process.* This is a key provision, defining the rights of each party to obtain an appraisal, and involving a single arbitrator/appraiser or a panel of two or three appraisers. The agreement must decide when the arbitrator(s) will be chosen—at the start of the engagement (preferable) or after a dispute has arisen; and who will choose the appraiser(s). A "shotgun" approach permits one party to provide the value, the other party to choose the share. Rights of first refusal can also provide a sanity check.

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- *Appraiser qualifications.* Some buy-sell agreements identify a specific appraiser or list of appraisal firms; others address the credentials and specific qualifications of the appraiser, such as practice scope, industry expertise, education, and training. Without these, a real estate appraiser or general accountant could qualify. Provisions can also identify specific appraisal standards of various professional societies or the IRS.
- *Payment provisions.* How will the agreed-upon value be provided to the departing or deceased shareholder? Can the company afford the price? What funding mechanism will be used?
- *Miscellaneous.* Additional provisions can address time limits for each step of the appraisal, provisions to break deadlocks, alternative dispute mechanisms, and third party involvement. Some buy-sell agreements even provide for psychological or "family" counseling to reduce conflict and ease the transition.

In Finding 'Bad Deeds,' Court-Appointed Valuation Exceeds Scope of Duties

In the Matter of P.J. Lynch Food Service, Inc., et al., 2006 N.Y. App. Div. LEXIS 9133 (July 11, 2006)

A 40% shareholder (who was also a manager/director) of this food service company successfully petitioned the lower court to dissolve the company. In doing so, the court appointed a forensic accountant to value the company. The accountant submitted a report determining the company to be worth $858,900.

Accountant's supplemental report causes problems

While preparing his report, the accountant uncovered certain "potential assets and liabilities" that merited separate consideration. Because these were related to the minority stockholder's sole stewardship of the company, the accountant issued a supplemental report, calculating the minority's liability at $2,167,400.

The majority stockholder requested the lower court to confirm the valuation and compel the minority to turn over his shares of the company. The court did both, and, in considering the supplemental report, it focused on which assets the minority still held and which liabilities were attributable to him. As none of these could be "valued with precision," the court declined to consider each alleged malfeasance by the minority, but instead found that his liability was approximately equal to his equity interest and ordered him to turn over his share—without compensation.

Impermissible delegation of the court's power

On review, the appeals court found that "submission of the supplemental report, purporting to determine [the minority's] liability to the company, exceeded the scope of the forensic accountant's authority pursuant to the order appointing it."

Even if the trial court had granted the accountant authority to determine liability between the parties, any such grant was an "impermissible" delegation of the court's adjudicatory powers to make its own independent findings of fact and conclusions of law. Accordingly, the appeals court sent the case back for a hearing on the company's value and the minority stockholder's liability to the company, if any.

Must an ESOP Appraisal Consider Potential Sale Negotiations?

***Kennedy v. Trustmark Nat'l Bank,* 2006 U.S. Dist. LEXIS 59079 (August 22, 2006)**

This is a buy-sell case in which an ESOP appraisal furnished the fair market value of the stock. A stockholder was cashed out at a certain price, only to learn a year later that the company sold for nearly three times the price. But the plaintiff was unable to turn this into a case of a corporate fraud and conspiracy—in large part because the ESOP appraisal was competent and clear and the buy-sell agreement was unambiguous.

A case of rightful termination

After twenty-seven years at an insurance company, the plaintiff (a vice president) had been named a defendant in a criminal action and was lawfully terminated. At the time, he owned 300 shares in the company and, pursuant to the buy-sell agreement, was entitled to receive the stock's "fair market value" on the company's choice of either: (1) the ESOP valuation date coinciding with or immediately preceding his termination; or (2) the date on which he was terminated.

The company picked the former, using an annual ESOP valuation that took place at year's end, just

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fifteen days prior to the plaintiff's termination. The appraisal determined a fair market value of $1,516 per share, which the plaintiff received. Ten months later the company sold for about $4,000 per share.

The plaintiff claimed the sale amounted to a fraudulent scheme to cheat him out of the $750,000 difference. He also alleged that the buy-out price was based on book value rather than fair market value and that the company had failed to inform the appraiser of its imminent sale.

On defendant's summary judgment motion, the District Court found it "unequivocal" that the buy-sell agreement provided for a fair market valuation of the stock as of the year-end ESOP appraisal. "The fair market value of plaintiff's stock was not required, or even permitted, to be determined ten months later when the sale…occurred."

Further, the Court found "not even a scintilla of evidence" that the plaintiff received book value instead of fair market value. The valuation report specifically addressed the company's book value—which on a per-share basis equaled $418—and noted that "book value, per se, is typically not given much weight… unless, on a liquidation basis, it exceeds the value as calculated using methods related to the earning power of the Company." Instead, the fair market valuation was based on "methods utilizing market comparable data," according to the appraiser's affidavit, "and the capitalization of the Company's earning capacity."

The appraiser knew about the sales discussions

The appraiser had been aware of management's "conversations" with a potential buyer. But as of the valuation date, there had been no letter of intent, no final terms, and no settled transaction. Not even the majority shareholders (whose approval would have been required for a sale) knew about the discussions. As such:

> [I]t would have been inappropriate and pointless to utilize, reference, or give credence to such uncertain, imprecise information and unsettled activities…for determining the controlling interest value of the company for ESOP purposes. Even if there had been firm or finalized terms of the sale…prior to [the] issuance of the Valuation Report, this subsequent information would not have been used in making a [prior] year-end valuation determination.

Based on this evidence, the Court found plaintiff's allegations "unsubstantiated… obviously made before reasonable inquiry," and without any knowledge of the appraisal process. The appraised fair market value of the stock was "comprehensive and accurate" and did not need to consider a sale which was, on the date of valuation, purely "speculative and uncertain."

Reasonable Comp. Analysis Rejected for Lack of Reasonable Comparables

Wechsler & Co. v. Comm'r of Internal Revenue, **2006 Tax Ct. Memo LEXIS 175 (August 17, 2006)**

The taxpayer's tactical strategy in this case may have backfired, as it chose to present two expert witnesses—one a notable financial analyst, and the other a compensation expert.

A broker-dealer like no other

During the early 1990s, the taxpayer operated primarily as a broker-dealer and investor in convertible bonds, with a portion of its own portfolio in hedged positions. The privately owned Wechsler & Co. also functioned as "market maker" for thinly traded securities.

With the advent of electronic trading, the company's president and controlling shareholder (Wechsler) lost his advantage as an expert market-maker. The company went from listing approximately 350 securities per year to just 30 or 50; it had also reduced staff from a high of 53 employees (in 1992) to only 12 by 1999.

For all the years in question (1992-1997), the company paid Wechsler a base salary of approximately $390,000 per year and an annual bonus that varied from a high of $7.09 million in 1994 to a low of $1.3 million in 1997 (followed by another $7 million in 1998). It deducted all amounts as "reasonable compensation."

Upon review, the IRS disallowed deductions totaling $20,243,433.

Taxpayer's expert applies sophisticated analysis

The company's financial expert took data from 27 publicly traded broker-dealers and averaged the ratios of: (1) aggregate compensation to net revenues; and (2) aggregate compensation to pre-tax income before compensation for each broker-dealer. He then compared these to similar ratios for the taxpayer.

Overall, with the exception of one year (1994), the expert concluded that Wechsler's compensation was reasonable, as it fell within industry averages, and he was the driving force behind the business. Further, the taxpayer had enjoyed a 10.4% compounded annual rate of return on its common stock equity, adjusted

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for deferred taxes. Most equity investors would find this a “highly satisfactory” rate of return.

Compensation expert may have hurt

But the company’s second expert—a consultant with 25 years of executive compensation experience—testified that he couldn’t find any broker-dealers “reasonably comparable” to the taxpayer. Given this gap, he had to analyze Wechsler’s compensation under the remaining factors of the Tax Court’s “multi-factor” test, including the employee’s role in the company, the company’s character and condition, conflicts of interest, and internal consistency. He concluded that the average compensation received by Wechsler over the years ($4,752,751) was reasonable.

But this expert did not analyze whether an independent investor would be satisfied with the rate of return on an investment in the company, as required by applicable 2nd Circuit precedent.

IRS offers simpler analysis

The IRS expert suggested an alternative method, based on incentive plans for hedge fund managers and a survey of financial companies. Under this approach, a disinterested shareholder would obtain most of the profits during the company’s good years and absorb all downside during the bad.

Emphasis on appropriate legal standard

The Court analyzed the evidence under the multi-factor, independent investor test, but found “no strong linkage…between the [company’s] financial performance in a given year and Mr. Wechsler’s bonuses and total compensation for that year.” The Court also agreed with the Service that the company’s compensation practice would “highly” disadvantage an independent investor, with a 10.4% compounded annual rate

The IRS’ percentage allocations were too low, however; Wechsler’s annual bonus should reflect his “exclusive” responsibility for the company and be closely tied to its performance. A yearly bonus equal to 20% of the company’s adjusted earnings before federal income tax (EBFIT) (before payment of bonuses) would be reasonable, the Court found, and also provide investors with a satisfactory, 16.3% compounded annual return.

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