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VALUATION Trends

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Buy-Sell Agreement Fuels War Over Workable Stock Appraisal Method

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

Ten years of litigation over a shareholder buy-sell agreement between parties that never agreed on the value for the shares of a closely held corporation have taken the litigants through four rounds of appeal, but no closer to an answer as to the appropriate valuation method.

The plaintiff served as the defendant's director of sales for the operation of a ski resort. In 1986, the parties made an agreement that promised him an 18 percent equity interest in the defendant's closely held corporation if he remained employed until year-end 1991. Under a contemporaneous buy-sell agreement, the defendant had the option to buy back the plaintiff's stock if, among other things, the employment ended.

The purchase price was to be "an amount agreed upon annually by the stockholders as set forth on the attached Schedule A." If the parties failed to establish an annual value, "the value shall be the last agreed upon value except that if no such agreed upon value is established for a period of two years, the value shall be the last agreed upon value increased or decreased by reference … the company's book value." The agreement listed the plaintiff as a "stockholder." No Schedule A exists.

In 2003, the plaintiff sued in state court (Supreme Court, Monroe County, which is a trial court) for specific performance of the stock issuance. Moreover, he requested an order that, once the stock was issued, the defendant had an obligation to repurchase it and a determination of the parties' rights and duties under the buy-sell agreement. The trial court directed the defendant to issue 18 percent of its shares of stock to the plaintiff, which the defendant subsequently did. The court also ordered the parties to execute the buy-sell agreement and fix a price for the purchase. Specifically, it valued the buy-back interest at an amount that aligned with a prior buyout involving a different shareholder. Both sides appealed.

Volley of appeals. In 2005, the defendant sought dismissal of the complaint, arguing that it was time-barred. The appellate court declined. At the same time, it granted the plaintiff's request to overturn the lower court's setting a price for the purchase of his shares.

In 2006, the trial court directed the defendant to repurchase the stock for approximately $110,000, based on the defendant's claim that the method to value the stock was by prorating the value of its parent corporation among that company's three subsidiaries. The plaintiff appealed, contending that the agreement required that the two stockholders of the defendant determine the value of the stock, not the owners of the parent corporation. He also provided a letter he had received from the defendant's attorney in 1999 that specified a different valuation method. The appellate court ruled for the plaintiff.

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In 2009, the trial court denied the plaintiff's request for a determination that his shares "be valued on the basis of his percentage interest in the Defendant's assets" in the event that the defendant exercised its option to buy back the shares. He advocated for the use of a net asset approach that the state's highest court had approved in a case about the buyout of a law firm partner pursuant to an agreement that provided for a future agreement among partners that never came into existence.

The plaintiff appealed, contending that the agreement's purchase price provision was unenforceable. The defendant presented other stock valuations. The appellate court said the plaintiff showed "as a matter of law that the stockholders have never agreed upon a value of the stock." Accordingly, there was no way to ascertain his share price in accordance with the terms of the buy-sell agreement. Evidence of stock valuations from other transactions was of no consequence because the plaintiff was not a party to them.

'No uniform rule for valuing stock.' In 2011, the trial court denied the defendant's motion to set the stock purchase price at approximately $184,000 based on its expert's calculation. The expert had used the same formula the plaintiff proposed in 2009.

The appellate court affirmed the denial. Its 2010 ruling notwithstanding, it stated it did not then require a net asset valuation, a method the high court approved but did not mandate. The court clarified that its earlier decision established that the plaintiff's shares had to be valued "on the basis of his percentage interest." However, issues of fact as to what the appropriate method for valuing the defendants' assets remained.

The court rejected the defendant's claim that the buy-sell agreement's reference to book value dictated its use to determine the price for the plaintiff's shares. The parties never agreed on the value of the shares, and there was no adjustment to be made. "Book value does not come into play." In this vein, it also noted that, even though, under provisions of the business corporation law, the plaintiff had no right to the "fair value" of the stock, "it does not follow … that the plaintiff is entitled only to book value."

There is "no uniform rule for valuing stock in closely held corporations," the appellate court stated. A court must tailor the valuation method to a particular case, based on the evidence at trial.

The appellate court, however, agreed with the defendant that the trial court had erred in finding the defendant had exercised its option to buy back the shares. The plaintiff earlier had raised the issue in an inappropriate manner. A resolution of this question could wait until the defendant actually refused to buy the shares at the price the lower court set after a trial on the value of the shares, the appellate court concluded.

Editor's note: New York attorney Peter Mahler, in reporting on the case in his blog, notes that the parties could have avoided years of litigation had they prepared a simple schedule or certificate of value in accordance with the agreement. But no one must think this omission is a "freak occurrence." "Rather," Mahler says, "it is symptomatic of the myriad problems afflicting fixed-price buy-sell agreements."

Court Accepts Cost Approach to Calculate Value of Lost Business

The 5th Circuit Court of Appeals considered how to measure damages for a facility with no real market when it reviewed the district court's $3.8 million award to the plaintiff related to a destroyed waste treatment plant.

The defendants owned and operated a Texas oil refinery that contained a third party's waste treatment plant. After an explosion destroyed the plant, its owner filed an insurance claim with the plaintiff and received payment of $6.1 million. The insurance company sued the refinery's owners to recover damages, and the latter stipulated to liability. At a bench trial, both parties agreed that damages should be the fair market value (FMV) of the plant before the explosion but disagreed over how to determine FMV.

The plaintiff argued that there was no market for the type of facility that existed before the accident that could provide a measure of value. Its expert stated that it would be “highly uncommon” to build a plant such as the one destroyed “completely out of used equipment.” Therefore, it sought the adjusted replacement cost.

The defendants claimed they were only liable for the cost of the plant’s components and that used versions of those were available from vendors.

Both sides presented damages experts. The plaintiff’s appraiser considered the remaining life of the original plant at the time of the explosion for his calculation. Without this adjustment to the replacement costs, he said, the plaintiff would receive a windfall. Since the original equipment was no longer available, he met with plant employees, explained depreciation and how to calculate it, and adopted their estimate. This, he stated, was the method he had used in the past. He was surprised by the employees’ “aggressive” and low estimate that the facility only had 65% of its remaining life but believed it was reliable. He also considered statements from an employee who identified nearly three-quarters of the equipment that was at the plant and tried to obtain price quotes from vendors.

The plaintiff’s industry expert spoke to the multiplier that should apply to the underlying cost figure to account for anticipated costs related to the construction. There are different ways to look at multipliers, he said: take either a percentage of value, “say a hundred percent of cost increase,” or two times the original amount. Also, multipliers, although not ideal, were appropriate because there was no better information available. He recommended a 2.5 multiplier. In the past, multipliers ranging from 1.8 to 3.2 when building the type of plant that was at issue. Based on their experts’ calculations, the plaintiff sought $6.1 million—or precisely the amount the plaintiffs had already paid out for lost value.

The defendant’s expert based his calculation on the cost of the plant’s component parts. He did not account for installation, on-site engineering, or startup. Rather, his damages figure covered equipment that was “sitting on the ground, not assembled.” He noted that experts generally disfavor the use of multipliers “for their inaccuracy” and that they were only appropriate “for broad cost estimates.” A multiplier was inappropriate in this case, he concluded. Total damages were no more than $878,000.

The district court found that, although there was a market for the components making up the plant, there wasn’t one for the company’s used waste treatment system. Since the market value of a fully operational plant was greater than the sum of the components, the measure of value was the adjusted replacement cost. It estimated that new equipment, including taxes and shipping, costs approximately $2.3 million. The court added 10% as a contingency. It then multiplied the combined amount by 2.25 and multiplied the result by 0.65 to account for the 35% depreciation the plaintiff’s expert had proposed, arriving at a total of $3.8 million in damages.

The defendants appealed on three grounds, stating the district court erred when it: (1) used replacement cost to determine the market value of the plant; (2) admitted the plaintiff’s expert testimony regarding the 35% depreciation; and (3) used a 2.25 multiplier that lacked a factual basis. The Court of Appeals considered the objections in turn.

1. Replacement cost. Prior case law stood for the proposition that “evidence of replacement cost is no evidence of market value damages,” the defendants claimed. The district court should have measured the plant’s market value by pricing the individual components that were likely present at the facility before the accident.

At the outset, the appellate court noted that the defendants read a much broader meaning into the cited case, which concerned a totaled

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car, than it supported and this was not sufficient evidence to prove damages. In this case, the Court of Appeals pointed out, the plaintiff offered much more proof when it "utilized the services of an appraiser to determine the value of [the facility]."

Also, the destroyed plant was not like a totaled car, whose market value emerges by looking at comparable sales in a specific geographic area. In this case, each facility had proprietary components, and the plant's underlying process was patented. Further, in their appeal, the defendants failed to address the finding that no market exists, insisting instead that their ability to price out components precluded the use of replacement cost as a measure of damages. The district court had discretion to consider the countervailing arguments, and its decision duly considered the labor, layout, and installation of the plant. Replacement cost was the appropriate measure of damages, the Court of Appeals stated.

2. Inadmissible expert testimony. Beyond relying on the employees' estimate as to how much life the plant had left before the explosion, the plaintiff's expert did nothing to calculate the depreciation, the defendants claimed. This uncritical adoption made his testimony inadmissible under Rule 703 of the Federal Rules of Evidence, which requires an expert to bring his professional judgment to the use of data he receives from external sources. The plaintiff countered that the expert had explained how he had arrived at the factors he had used to determine the plant's depreciated value.

The Court of Appeals agreed with the defendants that the depreciation aspect of the testimony was problematic. Although he "clearly articulated what depreciation means and how it is usually calculated," he did not describe the particular experience he brought to the process. At the same time, there was no way to verify whether they acted in accordance with his instructions. That said, the court continued, "insofar as he educated and interviewed [the employees], [the expert] did more than just repeat information gleaned from external sources." Also, he showed that he was familiar with appraising heavy industrial plants "broadly," if not the type of plant at issue.

Finally, it was important to consider what was "feasible," the court said. Although he could have developed a more accurate estimate "by inspecting records or the equipment itself," neither was available. He consulted one of the few sources of information to which he had access: the employees. Under the circumstances, the district court was in the best position to assess the admissibility of his testimony.

3. Multiplier. There was no basis for the plaintiff's proffered 2.5 multiplier and the district court's 2.25 figure, the defendants claimed.

The appellate court disagreed. There were few records to estimate the cost of rebuilding the plants, a situation which "counsels in favor of using a multiplier," it stated. The district court received two permissible views on multipliers and used one that was well within the range the experts proposed and that was consistent with experience as to those plants. For all these reasons, the Court of Appeals upheld the award.

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