TRUGMAN Valuation

VALUATION Trends

Summer 2016

Shareholder Agreement Sparks Suit Over Discount Use in Fair Market Value Calculation

In re Estate of Bittner,* 2016 Pa. Super. Unpub. LEXIS 179 (Jan. 21, 2016) *(Bittner II); In re Estate of Bittner,* 2014 Pa. Dist. & Cnty. Dec. LEXIS 857 (Sept. 17, 2014) *(Bittner I)

Are discounts a given in a fair market value determination? This question was at the heart of a buyback dispute involving two closely-held family businesses and an ambiguous shareholder agreement that governed the transaction. The executors and the beneficiaries of the decedent minority shareholder's estate argued over whether the plain language of the agreement prohibited the application of discounts for lack of marketability and lack of control. The court resorted to a business valuation expert and lay opinion testimony to resolve the issue.

The decedent owned minority interests in two closely-held family entities. The decedent's will specified that his wife and son were each beneficiaries of 25 percent of the decedent's residual estate. The shareholder agreement applicable to both companies provided that each company had an option to buy back all of the decedent's common stock at a price equal to the fair market value ("FMV") of the stock, which the companies were prepared to do.

A key provision in the shareholder agreement stated in relevant part that the FMV of the stock being transferred meant "that amount determined by the Shareholders to be the per share fair market value of the Company issuing such Common Stock … for the calendar year of the transfer, multiplied by the number of shares of Common Stock being transferred." The provision went on to say that, if the shareholders failed to determine the "per share fair market value" of the company for the year of transfer, the company should hire a CPA to determine that value.

After the decedent died, the co-executors of his will (the decedent's brother and a bank) valued the stock by applying discounts for lack of control and lack of marketability. The combined value of the stock was slightly less than $720,000.

The beneficiaries contested the stock's valuation. At a hearing in front of the probate court, they claimed the plain language of the shareholder agreement militated against the use of discounts. In calculating the FMV of the stock "no discounts should have been applied, the value should have been calculated on a pro rata basis." They claimed that, in discounting the value of the decedent's stock, the executors violated the agreement and breached their fiduciary duty. According to the beneficiaries, the pro rata valuation of the shares was about $1.1 million. The executors countered that the language of the agreement was ambiguous. Consequently, there was a need for the introduction of extrinsic evidence (parole evidence) to clarify the terms of the contract. The probate court agreed to hear testimony on the matter.

The beneficiaries, standing by their position that the shareholder agreement was unambiguous, offered no testimony or evidence.

The executors presented expert witnesses and lay testimony to support their interpretation of the agreement. A representative of the bank that served as co-executor testified that "discounts for lack of marketability and lack of control when there's a calculation of fair market value" of minority shares in a closely-held corporation are "always" a "component of developing the fair market value"

Continued on next page...

In this issue

- Shareholder Agreement Sparks Suit Over Discount Use in Fair Market Value Calculation
- Goodwill Snafu Invalidates Noncompete Agreement
- Latest New York Statutory Fair Value Ruling Nixes DLOM
- Florida Court Revisits Active-Passive Appreciation Issue
- Proposed Regulations Under IRS Code Section 2704

of the shares.

The CPA who was retained by the issuing companies to value the stock in this matter testified that the term "fair market value," as it appeared in the shareholder agreement, was well defined in the business valuation community. "When you're valuing a minority interest in a closely-held business as [here, the term includes] adjustments for the lack of control and lack of marketability that exists with that non-controlling ownership interest." The expert went on to say, "the term 'per share fair market value' equates to the fair market value of the equity interest being valued."

According to the expert, "discounts for lack of control and lack of marketability are inherent in the fair market value concept" for minority interests in closely-held corporations. He added that a prior valuation of the stock of the issuing companies also adjusted for lack of control and lack of marketability and none of the stockholders objected to the valuation. The expert noted that not accounting for lack of control and marketability in a fair market value determination was "nonsensical" because without the discounts "the corporations would be forced to buy the shares back at a price that was higher than fair market value."

Finally, the decedent's brother who was one of the signatories of the shareholder agreements said that, when using the term "fair market value," it was not his intent to "just take the total company value and then just distribute the *pro rata* portion of it."

Following the hearing, the probate court found that the agreement was "inherently ambiguous." It said the agreement's requirement that the share price be the "per share fair market value of such Company" allowed for two reasonable interpretations.

Under the beneficiaries' interpretation, there was a need "to calculate the total fair market value of the entire company first and then simply divide by the number of shares." According to the court, "this interpretation assumes that 'fair market value' specifically refers to the 'Company.'"

Under the co-executors' equally reasonable interpretation, the shareholder agreement required an assessment of the FMV of the shares themselves, "including an analysis of the specific shares to be transferred," followed by a calculation of the value of the transferred shares, the court said. This interpretation assumed that "fair market value" refers to the shares themselves as opposed to the company as a whole, the court added.

The court said it was necessary to consider parole evidence to uncover the meaning of the agreement's provisions. The court also noted with disapproval the beneficiaries' failure to produce any testimony or evidence, and it adopted the executors' interpretations and discounted value. However, the court did note that the executors' interpretation "renders the method of calculation [the requirement that the per share value be calculated, then multiplied by the number of shares being transferred] as surplusage." But, said the court, this interpretation "does not gut the clear and essential mandate that the stock be assessed at 'fair market value.'"

The beneficiaries unsuccessfully challenged the ruling at the state's intermediary appellate court, which adopted the lower court's ruling with approval. The appeals court declined to comment on the appellants' various claims. Accordingly, the decedents' shares in the issuing companies were subject to discounts for lack of control and marketability.

Goodwill Snafu Invalidates Noncompete Agreement

Healthcare v. Orr, **2016 Cal. App. Unpub. LEXIS 440 (Jan. 20, 2016)**

Valuators know that the interplay between goodwill and a noncompete is a tricky issue. A recent California case arising out of the sale of a medical practice complicates the picture, but also provides a bright-line rule as to how to value a business so as to ensure the noncompete is enforceable.

A California-based doctor who wanted to sell her medical practice entered into negotiations with a larger healthcare provider. The potential buyer offered $1.7 million for the building, which the doctor owned, but said the medical practice had no monetary or goodwill value. The doctor responded she was not "comfortable with the concept that my business/practice has no value" and that she planned to continue her current practice.

Eventually, the parties came to an agreement. The asset purchase agreement specified a price of about $34,700 for the medical practice. It provided that the assets being sold included "[a]ll of the goodwill of The Medical Practice," but it allocated 100 percent of the purchase price to "[f]urniture, fixtures, equipment and supplies." As part of the sale, the doctor was offered employment with the

buyer and in exchange signed noncompete and nonsolicitation agreements.

When the doctor later decided to reactivate her practice, albeit in a different form, the buyer filed a complaint alleging breach of contract, interference with contract and unfair business practices. It asked the trial court for a temporary restraining order against the doctor. The court granted the injunction as it related to the solicitation of patients but did not prohibit the doctor from starting up a new practice.

The doctor subsequently challenged the injunction with the California Court of Appeal, arguing the trial court's ruling was an abuse of discretion.

The appeals court agreed. It noted that, under California's Business and Professions Code, noncompete and nonsolicitation clauses are generally not enforceable. But there is an exception for persons who sell the goodwill of a business. The law recognizes that it would be "unfair" to allow the seller to compete in a way that diminishes the value of the asset he or she sold to the buyer. Under controlling case law, for the exception to apply, "there must be a clear indication that in the sales transaction, the parties valued or considered goodwill as a component of the sales price."

Here, the Court of Appeal found that the buyer did not pay anything for the practice's goodwill. Although the asset purchase agreement stated that the goodwill of the seller's medical practice was among the assets sold, it allocated no portion of the $34,700 purchase price to goodwill. Also, no part of the compensation offered to the doctor under the employment agreement was for the goodwill of the practice.

Since the buyer gave no consideration for the practice's goodwill, the noncompete and nonsolitication clauses "were neither necessary nor enforceable to protect the value of the goodwill because the parties agreed the goodwill had no value."

An appraiser wanting to protect a client's interest must know that in California a noncompete/ nonsolicitation agreement accompanying the sale of a business is only enforceable if the valuation allocates a percentage of the sales price to the business's goodwill.

Latest New York Statutory Fair Value Ruling Nixes DLOM

***Verghetta v Lawlor,* 2016 N.Y. Misc. LEXIS 845 (March 9, 2016)**

A New York trial court recently issued a decision in connection with the buyout of a minority shareholder that provides rich fare for valuation professionals. The court's somewhat unusual (for New York) take on the use of a marketability discount is only one of the issues making the ruling a treat.

The case involved three (roughly equal) partners who owned Planet Fitness franchises in two corporate entities. The minority owner sued the others, asking for a judicial dissolution, but they ultimately agreed to a fair value determination by the court. The plaintiff's expert was a tax lawyer with no valuation experience. In contrast, the defendants' expert was "a true valuation professional," as the court called him. The plaintiff's expert valued the two corporations at over $162 million and the seller's interest at over $53 million. The defendants' expert valued one of the entities at $6.2 million and the other at $208,000. He concluded that the plaintiff's one-third interest was worth approximately $2.2 million.

The court allowed the plaintiff's expert to testify on valuation but completely discredited his work product. At the same time, it had some harsh words for the defense expert's valuation as well. Ultimately, the court decided to use the defendant expert's basic approach and modify it to raise the value of the plaintiff's interest to $8.8 million.

One of the court's major adjustments was nixing the 35 percent discount for lack of marketability that the defendants' expert had applied. His report showed that only a portion of the discount rate related to marketability, and much of it related to a potential tax liability the expert saw, the court noted. However, he was unable to adequately explain when the unfavorable tax treatment would set in, the court said. It also dismissed the expert's rationale that there would be a prolonged holding period. His effort "to maximize Defendants' position by a 'high-end' discount is thus not persuasive," the court said. Citing the *Zelouf* case, the court noted that no New York appellate court ever held that a marketability discount was mandatory—especially not in a situation where the defendants made it clear that they were not planning to sell.

The court picked at other aspects of the defense valuation, including the defense expert's decision to normalize historic income by nearly doubling officers' compensation; his "roller-coaster" revenue growth model; and his decision to tax affect one company's earnings by 18.5 percent to account for its being a passthrough entity. The latter suggested he "was unduly focusing on the buyer's side of the

equation," the court noted.

In conclusion, in the latest New York statutory fair value ruling, the court noted that while it would have considered an entity-level discount for lack of marketability based on certain transfer restrictions operating on franchises, the expert's failure "to provide a basis for calculating the appropriate amount of the discount," as well as other factors, militated against the use of a DLOM.

Florida Court Revisits Active-Passive Appreciation Issue

Witt-Bahls v. Bahls, **2016 Fla. App. LEXIS 1451 (Feb. 3, 2016)**

The issue of active and passive appreciation of business assets in a divorce context is growing in prevalence. A noteworthy Florida ruling further explores the scope of appreciation: Does a nonowner spouse have a claim to the increased value of all nonmarital assets without showing marital effort or the use of marital assets to achieve the appreciation?

In this case, the husband did not own a business. Instead, before the marriage, he began working for a company and, at that time, also bought a large amount of company stock by way of a bank loan. During his tenure at the company he had some supervisory responsibility, but also had a couple of demotions. When he was terminated, his stock was liquidated. The shares sold for substantially more than the outstanding balance on the loan used to buy them.

The trial court determined that the stock was separate property and its increase in appreciation was passive; it was, therefore, not subject to marital distribution. The wife appealed the ruling. It seems she asked the appeals court to adopt a rule "that all appreciation of the stock of a company for which a spouse works is a marital asset." The Court of Appeal rejected the proposition.

Under the existing analytical framework, the court said, the increased value of stock from a company for which the owning spouse works *can* be a marital asset and subject to distribution. But, it can also be a nonmarital asset. The crux of the matter is "whether the husband exerted the sort of 'effort' required to move the appreciation value from the nonmarital category to the marital one," the court explained.

Cases that have found the appreciation was a marital asset typically involve a family-owned business in which the stock-owning spouse holds a significant position. Here, neither of these "key features" was present, the court found. The company the husband worked for was not owned or operated by his family. He held no significant managerial position in the company; at most, he was a "middle manager." He did not contribute to the appreciation in the value of his stock, and his wife had no right to any part of the stock's increased value.

Under Florida law, whether the appreciation in the value of nonmarital assets, particularly stock in a company, qualifies as a marital asset depends on both the nature of the company the stock-owning spouse works for and the position he or she holds in that company. In other words, the issue is whether the owner spouse can switch the appreciation from the passive to the active column.

Proposed Regulations Under IRS Code Section 2704

The *Bittner* cases discussed above were decided in the Pennsylvania courts. However, the definition of fair market value is the same as the one promulgated by the Department of Treasury and included in various code sections within the Internal Revenue Code. On August 2, 2016, Treasury released a proposed regulation under this code section that would eliminate discounts for lack of control and marketability in transactions in family owned businesses, both holding companies and operating companies. For those interested in learning more about this proposed regulation, click here.

If Treasury makes the decision to implement this proposal, it would be effective sometime in early 2017. This would result in the elimination of discounts, and therefore, higher values for transfer tax purposes. Therefore, we strongly recommend that you speak with your clients about expediting any transactions that are being considered.

©2016. No part of this newsletter may be reproduced or redistributed without the express written permission of the copyright holder. Although the information in this newsletter is believed to be reliable, we do not guarantee its accuracy, and such information may be condensed or incomplete. This newsletter is intended for information purposes only, and it is not intended as financial, investment, legal or consulting advice.

Florida
8751 W. Broward Blvd., Suite 203
Plantation, FL 33324
954-424-4343

New Jersey
2001 Route 46, Suite 310
Parsippany, NJ 07054
973-983-9790