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VALUATION Trends

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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 business 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

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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, and the other party to choose whether to be the buyer or seller. Rights of first refusal can also provide a sanity check.

- *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.

Intangible Asset Valuations: Spot These Common Errors Before Going into Court

When reviewing your expert's intangible asset valuation—or the opposing party's—it's critical to identify the most common errors that can cause a court to discredit or even disregard a report. The following checklist serves as a quick guide to avoid the most obvious deficiencies:

—*Is the standard of value followed?* Has the analyst carefully disclosed and defined the applicable standard of value? Has the standard of value been followed consistently throughout?

—*Are all three valuation methods considered?* These include the income, market, and asset approaches.

—*Is the internal analysis consistent?* For example:

- Did the analyst match pricing multiples or capitalization rates to the wrong economic income measure?
- Are current intangible asset operational data matched to different time periods, without appropriate adjustment?
- Did the analyst "normalize" financial statements without also normalizing the corresponding data for selected comparable companies?
- Was a "highest and best use" analysis performed?
- Was an "actual use" analysis also performed?
- Did the analyst make extraordinary, subjective, or speculative assumptions?

—*Is there sufficient support for selected variables?* Any analyst should document the data used, the procedures performed, and the valuation conclusions reached. There should also be sufficient tracing from the data in the quantitative analysis to the intangible asset in the owner/operator financial statement.

—*Do the numbers add up?* Mathematical errors are more common than anyone cares to admit; check all numerical calculations for accuracy, and make sure rounding conventions are consistent.

—*Does the analyst rely too heavily on 'rules of thumb'?* These serve only as a "sanity check," not as a basis from which to derive substantial intangible asset valuations.

—*Is there sufficient data and research?* The analyst should have conducted all relevant research, clearly threading the data into the quantitative analysis and valuation conclusions.

—*Is there adequate due diligence?* The analyst should have reviewed all relevant contracts and corporate documentation, including internal financial statements and external marketing statements. Sales, licenses, contingent liabilities, and litigation should have also been considered.

Divorce Court Denies 'Marketability Discount' That Include Costs of Sale

***Anderson v. Anderson,* 2006 Tenn. App. LEXIS 592 (September 5, 2006)**

In valuing the husband's minority interest in a mobile home company, its CPA (and also the parties'

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joint expert) first determined its fair value as a going concern, which he estimated at just over $2.7 million. He then calculated 43.75% of that value, representing the husband's shares, and discounted this by 38.3% for lack of control.

Discount for marketability—or marketing?

The CPA then applied a 10% "marketability discount," which he said accounted for the costs to market the husband's business—including advertising, and broker's fees. On review, the Tennessee Court of Appeals accepted the CPA's initial valuation, which had referred to Revenue Ruling 59-60 factors (nature of the business, book value, economic outlook, etc.). It also accepted the discount for lack of control.

But the Court held that the application of the "marketability discount" was "inappropriate because no sale was ordered and there is no indication on the record that the husband has any intention of selling his minority stock."

It seems clear that the Court denied any discount for a contingency sale of the company, which the CPA had called a "marketability discount." What is not clear from the record is whether a true discount for lack of marketability might have applied to the husband's minority interest in the privately held corporation. The Court does recite case law imposing the burden on the parties to "produce competent evidence of value" at trial—and binding them to the evidence they do present—which implies that a discount for lack of marketability could have applied upon a credible showing by a competent appraiser.

Kohler*: Textbook Valuation of Large Closely Held Leads to Total Victory for Taxpayer*

***Kohler v. Comm'r of Internal Revenue,* 2006 Tax Ct. Memo LEXIS 156 (July 25, 2006)**

Everything went right for the taxpayer in the *Kohler* case. A leading manufacturer of kitchen and bath products, Kohler had been a privately held family business for nearly two hundred years, paying annual dividends since 1900. Kohler also issued two business plans: A management plan, which was a realistic projection of achievable targets; and an operations plan, which was a theoretical, "best case" projection. Kohler regularly updated its management plan for lenders and insurance companies; its operations plan was for internal use only.

Reorganization in 1998

To recapture the 4% of stock held outside the family, Kohler effected a tax-free reorganization (under §368(a) of the Internal Revenue Code). During the reorganization, on March 4, 1998, Frederic Kohler died. Kohler's estate retained the appraiser who had performed periodic valuations for the company, and he appraised the estate's holdings at a fair market value of $47.01 million as of September 4, 1998 (six months after decedent's death, the alternate date permissible under §2032 IRC). After an extended audit, the IRS determined the fair market value of the Kohler holdings on the alternate date to be $144.5 million.

A critical shift in taxpayer's favor

In most cases, the taxpayer must prove that IRS deficiency notices are incorrect; the burden shifts if the taxpayer can show well-maintained records and cooperation with the IRS. In this case, the Kohler estate had mounted an unsuccessful motion to quash, based on legitimate concerns for corporate confidentiality, but then it had complied with all IRS requests. The company's initial resistance did not obviate its subsequent and complete cooperation, which helped shift the burden to the IRS to prove that the taxpayer was liable.

The IRS also lost a bid to value the Kohler estate on the date of Frederic's death, because it missed a procedural deadline for amending its pleadings. The question still remained whether, on the alternate valuation date, the Kohler stock should be valued before or after the reorganization. The IRS tried to "back-door" its argument by claiming the Court should either: (a) value the pre-organization stock on the alternate valuation date; or (b) ignore the transfer restrictions and purchase option in valuing the post-organization stock. The taxpayer won on this point, too; pursuant to §2032(a) and accompanying regulations, a qualified, tax-free reorganization is not a "distribution, sale, or exchange" or other substantial change in form or value.

Credentials, USPAP certification are keys to valuation credibility

The narrow question then became the fair market value of the post-reorganization Kohler stock on the alternate valuation date. Given its decision on burden

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of proof, the Court first considered the IRS expert report, which lacked USPAP certification (Uniform Standards of Professional Appraisal Practice) regarding the appraiser's compliance with standards and independence. The Court also noted that the expert lacked valuation-specific credentials, although he was a Ph.D. and a CFA (Chartered Financial Analyst).

In his income approach, the expert had declined to use a dividend-based method, preferring a discounted cash flow (DCF) method instead. However, he opted not to use Kohler-provided projections, making his own expense assumptions "without first discussing them [with] anyone at Kohler," according to the Court. He created two DCF models, one using revenues from the company's management plan and the other from its operations plan, giving the former a 20% weight versus 80% for the latter, because he believed the "aspirational" plan was the more likely scenario. The Court disagreed, saying he weighted the results "inconsistent with reality of the business."

The IRS expert had also made a last-minute correction to his income approach values, which had overvalued the Kohler stock by $11 million—"not a minor mistake" according to the Court. He had also applied a market approach, using the guideline company method (80% weight) as well as the transaction method (20%), averaging the two and applying a 25% discount for lack of marketability.

In its final analysis, the Court found that: (1) the IRS had declined to use a dividend approach for a private company with a long and consistent dividend policy; (2) it had weighted a theoretical operations plan over a realistic management plan; and (3) it had failed to use management projections. The IRS had thus failed in its burden of proof. "Accordingly, we find the value of the estate's stock to be [as] reported on its return, $47,009,625."

Discussion of taxpayer's appraisal academic

The Court completed its record with high praise for the taxpayer's valuation reports, the one it had filed with its original return and a second report obtained for trial. Both appraisers were well-credentialed, with extensive professional, teaching, and publishing experience. Their reports provided "thoughtful, credible valuations" that strongly supported the estate. Highlights include:

- One appraiser was "very familiar" with company management and operations, having performed periodic valuations before; the second appraiser spent three and a half days at the company interviewing 12 employees, including considerable time with the president and the general counsel/executor of the estate.
- In their income approaches, both experts used a discounted dividend method, "important indicators of value where dividends represent the best, if not the only opportunity for minority shareholders to receive a cash return on…investment," the Court said.
- In their market approaches, both experts used the guideline company method, because there were insufficient comparables for the transaction method. One expert identified publicly traded companies in each market segment in which Kohler operated and applied multiples, weighting each valuation conclusion based on the relative portion of Kohler's business that each comprised.
- Both experts also applied a discount for lack of marketability under the DCF and capital market methods (45% and 35%, respectively) and a discount for lack of control (25% and 26%, respectively).

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