



## Buy-Sell Agreements From a Valuation Perspective

How shareholders and their advisors approach the drafting of these agreements may mitigate unintended valuation and tax-related consequences.

Valuation analysts are often involved in valuing closely held business interests pursuant to shareholders' buy-sell agreements, and may be involved in consulting engagements related to drafting certain provisions of these agreements. Buy-sell agreements tend to vary by type and complexity, and the parties involved should consider multiple factors from a valuation perspective when establishing these agreements.

### What Are Buy-Sell Agreements?

Buy-sell agreements govern equity transactions among shareholders in closely held businesses, or between the shareholders and the corporation. They do so by providing a mechanism for establishing the transaction price and providing for the funding and payment terms of a buyout upon certain triggering events. Examples of a triggering event can include a shareholder's death or disability, divorce, personal bankruptcy, or departure from the business. Buy-sell agreements may also contain

other governance provisions to ensure continuation of the business by providing an orderly transfer of ownership and providing restrictions on the transfer of shares to ensure that the ownership of the business does not end up with unrelated parties. Buy-sell agreements typically fall into one of three categories:

- 1 Corporate redemption agreements
- 2 Cross-purchase agreements
- 3 Hybrid agreements

In a corporate redemption agreement, the corporation is the purchaser of a shareholder's shares. In a cross-purchase agreement, one or more of the remaining shareholders purchase the selling shareholder's shares. A hybrid agreement is a combination of a corporate redemption agreement and a cross-purchase agreement, and provides the shareholders with flexibility to determine whom the purchaser will be. The shares may be offered first to the corporation and second to the other shareholders if the corporation does not elect to purchase them. Each type of agreement may provide for mandatory or optional redemptions or sales and can have different terms, depending on the nature of the triggering event.

Key factors impacting the decision on which type of agreement to use can vary depending on the primary objectives of the parties, the number of shareholders involved, the complexity of funding, and the associated tax attributes.

### Valuation Provisions of the Buy-Sell Agreement

Most of the mechanisms for setting prices in buy-sell agreements generally fall into the following categories:

- 1 Formula based on the financial statements, such as book value, adjusted book value, a multiple or weighted average of historical earnings, or a combination of such variables
- 2 Structured negotiation among the parties
- 3 Third-party valuation

## Formulas

The use of valuation formulas in buy-sell agreements is common. The reason is as simple as the formulas – they are easy to calculate and to communicate. However, formulas often fail to reflect fair market value, as described in the following paragraphs.

**The Problem of Timing:** Any fixed formula, to the extent it incorporates current economic rationale at inception, comports to market-based data as of a point in time. While a fixed formula may produce a meaningful result when the agreement is established, it will eventually become stale and obsolete as market conditions change and as the subject company changes. As all valuation formulas inherently reflect expectations of future returns as adjusted for risk, applicable valuation multiples change as a company's risk and return profiles change.

To illustrate, assume a valuation multiple is set at 5.0x. A valuation multiple, by definition, is effectively the inverse of a capitalization rate. Since a capitalization rate inherently captures assumptions about risk (the discount rate) and return (the growth rate), then the valuation multiple also reflects such assumptions.<sup>1</sup> As an example, a valuation multiple of 5.0x equates to a capitalization rate of 20%,<sup>2</sup> which may incorporate a discount rate of 23%, less a long-term growth rate of 3%.

To the extent expectations on future returns of the business change due to a decreased risk profile of the business and/or increased long-term growth prospects, assume that the appropriate discount rate should be 20% and the long-term growth rate should be 4%. This generates a capitalization rate of 16%, which equates to a valuation multiple of 6.25x.<sup>3</sup> This corresponding

increase in value will not be reflected with a fixed formula of 5.0x pursuant to the agreement. In this example, the remaining shareholders would benefit at the expense of the withdrawing shareholder.

### The Problem of Lacking Economic

**Rationale:** A formula may simply not reflect legitimate economic rationale. That is, the economic metric used in any formula should typically serve as a proxy for distributable cash flow. Distributable cash flow can be defined as cash flow that can be distributed to owners without impairing the operational viability of the business. Distributable cash flow can be measured discretely by adjusting expected enterprise value to earnings before interest, taxes, depreciation, and amortization (EBITDA) for noncash expenses and the corresponding tax consequences, working capital requirements, and capital expenditures. Formulas typically use proxies for distributable cash flow such as EBITDA and net income. To the extent a formula does not reflect future distributable cash flow, it will likely fail to provide an accurate valuation.

An attempt to shortcut the valuation analysis into a formula may be appealing to shareholders acting harmoniously to provide a convenient, low-cost solution. However, a formula price will not properly account for fluctuations in capital markets, changes in the company's risk profile, growth prospects, and the company's strategic outlook. Using a formula approach for setting the price in a buy-sell agreement can easily become unfair to one party or another when the transaction eventually occurs, and typically reflects fair market value only by coincidence.

<sup>1</sup> A growth rate incorporated into a capitalization rate represents a perpetual growth rate.

<sup>2</sup> Equal to 1 divided by 5.0x.

<sup>3</sup> Discount rate of 20%, less growth rate of 4%, equals capitalization rate of 16%; 1 divided by 16% equals 6.25x.

## Structured Negotiations Among Parties

A buy-sell agreement can require a determination of value by the shareholders through structured negotiations. Such structured negotiations can take the form of an agreed-upon value or through reciprocal put and call option provisions. Agreed-upon values typically require shareholders to state a value, agreed to by all parties, on a periodic basis, such as annually. If a triggering event occurs within a specified period of time, the agreed-upon value will apply. In practice, most parties fail to update the value routinely, or cannot agree on a price. In addition, it may be difficult to derive an economically reliable value without incurring professional fees.

Reciprocal put and call option provisions (sometimes called a shotgun approach) ensure a determination of value. Such a process conveys duality upon an offer. That is, a shareholder's offer to purchase another owner's shares can become both an offer to buy and an offer to sell at the price at which the initial offer is made. Accordingly, if an offer is rejected by the potential seller, it becomes a put option for the potential buyer; or if it is rejected by the potential buyer, it becomes a call option for the potential seller.

To illustrate, assume Shareholder A owns half of a company's 20,000 shares of common stock and Shareholder B owns the other half. If Shareholder A offered to purchase Shareholder B's stock at \$100 per share, Shareholder B, in declining the offer, would be forced to buy (and Shareholder A would be forced to sell) Shareholder A's stock at the same purchase price of \$100 per share. As any offer to purchase shares inherently includes a disincentive to propose a purchase price above fair value, the put/call process also creates

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a disincentive for Shareholder A to propose a price less than fair value. However, in situations where there is disproportionate ownership between the parties (e.g., one shareholder owning 90% and the other owning 10%), this method may not provide a true mechanism for a market clearing if the party with a disproportionately low ownership percentage does not have the financial wherewithal to be a buyer of the other shareholder's interest.

## Third-Party Valuations

Third-party valuations possess some clear advantages over structured negotiations. Frequently, to save on costs and to prevent a lengthy process, a single binding or nonbinding third-party valuation is performed by a valuation firm that works on behalf of both parties. Shareholders may often fail to agree on which valuation firm should provide the single valuation. For this reason, the process of selecting a valuation consultant should be well-structured and clearly defined as it relates to both the selection method and qualifications.

Assuming the shareholders select a valuation firm with the appropriate level of expertise, a third-party valuation should provide an accurate and well-reasoned analysis and conclusion. In nonbinding situations, the valuation report should provide persuasive market-based evidence. To the extent practical, each party should have the opportunity to participate in the valuation process by providing thoughts, opinions, and commentary.

It is common for buy-sell agreements requiring third-party valuations to oblige each party to hire his or her own valuation expert. In these situations, buy-sell agreements must contain provisions for reconciling differences between the valuations. To the extent the difference is relatively immaterial (e.g., within a 20% range), then a value based on the average of the valuations may be acceptable.

To the extent the differences are material, certain mechanisms can provide a resolution, such as hiring a third valuation expert to provide an additional valuation (and take the average of the two closest conclusions), or having the third expert choose one of the original valuations as being the binding valuation. In addition to saving the cost and time of an additional valuation, this stipulation helps deter valuation experts from taking extreme positions or posturing for their clients, either intentionally or subconsciously.

The likelihood of two third-party valuations differing significantly in their conclusions of value can be mitigated by well-defined and consistent valuation terminology within the buy-sell agreement. Proper definitions will, at a minimum, detail the level of value (e.g., whether discounts for lack of control and lack of marketability should be considered), the valuation date, and the standard of value. The agreement should clarify whether the value should be determined according to a particular perspective, such as that of a hypothetical buyer, the specific parties to the agreement, or a controlling shareholder.

The buy-sell agreement can also be structured to vary depending on the triggering purchase event. For example, the agreement may provide that in the event of a shareholder death, the purchase price should be established based on the fair market value determined by a third-party valuation, consistent with the definition of value for estate tax reporting purposes. Alternatively, the agreement may provide that the purchase price be based on book value to discourage a transfer of shares to an unrelated third party.

### Gift and Estate Tax Considerations

The IRS has historically viewed buy-sell agreements for family-owned businesses with skepticism. Consequently, there is a long history of Tax Court case law where the IRS challenged values fixed under the terms of the agreement as not being bona fide arm's-length market prices.<sup>4</sup>

For example, in *Estate of True v. Commissioner*, the U.S. Tax Court focused on the four-prong test previously established in *Estate of Lauder v. Commissioner* in which the formula price under a buy-sell agreement was considered binding for estate tax purposes if:

- 1 The offering price was fixed and determinable under the agreement.
- 2 The agreement was binding on the parties both during life and after death.
- 3 The agreement was entered into for bona fide business reasons.
- 4 The agreement was not a substitute for a testamentary disposition.

The Tax Court found that the first three prongs of the test were satisfied, but concluded that the fourth prong was not passed. In arriving at this conclusion, the Tax Court observed that there was no negotiation of the buy-sell agreement terms, there was no significant professional advice in selecting a formula price, the family failed to obtain or rely on appraisals in selecting formula pricing, significant assets were excluded from the formula price, and there was no periodic review of the formula price.

The U.S. Court of Appeals reiterated the Tax Court's conclusions and provided additional guidance with respect to the fourth prong of the test, noting that examination of a variety of factors should be considered in determining whether the buy-sell agreement served as a testamentary device. These factors include:

- 1 The health or age of the decedent when entering into the buy-sell agreement.
- 2 The lack of regular enforcement of the agreement.
- 3 The exclusion of significant assets from the agreement.
- 4 The arbitrary manner in which the price term was selected, including the failure to obtain appraisals or seek professional advice.
- 5 The lack of negotiation between the parties in reaching the agreement terms.
- 6 Whether the agreement allowed for adjustments or revaluation of its price terms.
- 7 Whether all the parties to the agreement were equally bound to its terms.

- 8 Any other evidence highlighting that the agreement supported the decedent's testamentary plan.

The Court of Appeals agreed with the Tax Court's conclusion that the company's buy-sell agreements were testamentary substitutes in light of the facts and circumstances surrounding the creation and terms of these agreements. Another aspect of this case involved the adequacy of consideration test. The Tax Court concluded, and the Court of Appeals agreed, that the formulas in the subject agreements were not comparable to what persons with adverse interests dealing at arm's length would accept and that they did not bear a reasonable relationship to fair market value.

Additional guidance is provided through Treasury regulations. Treasury Reg. §20.2030-2(h), as amended in 1992, established the criteria that must be complied with for the valuation pursuant to a buy-sell agreement in order to determine value for estate tax purposes. In addition, Section 2703 of Chapter 14 of the Internal Revenue Code provides special valuation rules that apply to any family-owned business in which the family members control 50% or more of the vote or value of the company.<sup>5</sup> These rules were designed to prevent potential succession-planning abuses related to the transfer of shares from senior generations to junior generations based on artificially low prices established in shareholder agreements. Specifically, any buy-sell agreement that establishes a price less than fair market value<sup>6</sup> (without regard to the agreement) will be ignored for gift and estate tax purposes.

In short, Tax Court cases have generally held that the most important criterion that a buy-sell agreement must meet to set the value for estate tax purposes

<sup>4</sup> Refer to *Estate of Lauder v. Commissioner*, T.C. Memo 1992-756; *Estate of True v. Commissioner*, T.C. Memo 2001-167, affirmed U.S. Court of Appeals for the Tenth Circuit, Nos. 02-9010, 02-9011, 02-9012 (2004); *Estate of Blount v. Commissioner*, T.C. Memo 2004-116, affirmed U.S. Court of Appeals for the Eleventh Circuit, No. 04-15015 (2005).

<sup>5</sup> Treas. Reg. §25.2703.

<sup>6</sup> Fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." (Treas. Reg. §20.2031-1(b)).

is to demonstrate that the price was established on an arm's-length basis. A fixed value based on a buy-sell agreement may be legally binding on the estate for transaction purposes even if it is not binding on the IRS for estate tax purposes. This could result in a situation where the estate pays taxes based on a value that is substantially higher than the price the estate actually receives.

### Best Practices

**Teamwork:** Numerous legal, funding, income tax, estate tax, and other practical issues need to be considered and addressed in drafting buy-sell agreements. While one of the objectives of the buy-sell agreement may be to avoid controversy or the need for negotiations among family members, a hastily drafted agreement can result in the exact opposite, leading to a lengthy process and expensive litigation. Accordingly, a team of advisors should be consulted in the drafting of a buy-sell agreement, which may include a corporate attorney, an estate planning attorney, tax and insurance professionals, and/or a valuation consultant.

**Time:** Within the provisions of the agreement, allow for ample time following a triggering event to administer the purchase or redemption process. The shareholders and corporation are likely to consult with legal advisors and other professionals. To the extent the agreement provides for an independent valuation, consider the time necessary to complete the valuation, which includes gathering information, conducting due diligence meetings and site visits, performing market research, and completing the analysis. Also factor in the time necessary for the parties to review the valuation and for legal advisors to provide any necessary legal determinations regarding the interpretation of the agreement.

**Retaining a valuation consultant to review certain portions of the buy-sell agreement pertaining to definitions of value can minimize the potential for misinterpretation.**

**Clear Definitions:** To the extent an independent valuation mechanism is used to determine the transaction price, the buy-sell agreement should provide a clear definition of value and description of the intended level of value to be determined. For example, the agreement should clarify whether the valuation analyst should consider the application of valuation discounts for lack of control and lack of marketability (similar to how a hypothetical party would view the value of the shares of a minority interest in a closely held company). Alternatively, the agreement should state whether the intention is to determine price based on the pro rata equity value of the entire corporation, which would tend to exclude the application of valuation discounts. Retaining a valuation consultant to review certain portions of the buy-sell agreement pertaining to definitions of value can minimize the potential for misinterpretation.

### The Benefits of an Independent Valuation

Poorly drafted and ambiguous buy-sell agreements can hinder transactions and generate significant costs and delays for the parties involved. Too often, the incorporation of formulas for this purpose in lieu of either structured negotiations or third-party valuations creates lengthy and expensive shareholder disputes. A properly drafted buy-sell agreement should present options that allow for changing facts and circumstances associated with the company and its shareholders.

Regarding the provisions related to purchase price, when practical, the price should be determined based on an independent third-party valuation as of the date of the triggering event. The valuation consultant will consider all relevant facts; employ the proper valuation approaches, such as the income approach, market approach, and asset approach; and apply the proper adjustments, as warranted. A third-party valuation provides reliable support to defend challenges to a buy-sell agreement, whether from family members or the IRS.

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