Business Valuation

Investment Banking

MERCER CAPITAL

Because Value Matters

VALUE ADDED™

Business Valuation • Investment Banking

No. 4 Volume 17 • 2005

HEADQUARTERS
5860 Ridgeway Ctr. Parkway
Suite 400
Memphis, TN 38120
Phone: 901.685.2120
Fax: 901.685.2199

MIDWEST OFFICE
511 South 5th Street
Suite 206
Louisville, KY 40202
Phone: 502.585.6340
Fax: 502.585.6345

mcm@mercercapital.com
www.mercercapital.com

IN THIS ISSUE

MERCER CAPITAL

YOUR CORPORATE BUY-SELL AGREEMENT

Six Defining Elements of a Buy-Sell Agreement

PART TWO

As business appraisers, we are often asked to provide opinions of value in the context of the operation of a buy-sell agreement. While this might appear to be a relatively straightforward task, over time we have found that many buy-sell agreements are poorly drafted. They fail to clearly communicate the intentions of the parties. Therefore, disagreement ensues when it becomes apparent that the agreement doesn't say what everyone thought it said.

We are business appraisers, not lawyers, so we share advice strictly from a business appraiser's perspective. That advice is that it is important that anyone drafting a buy-sell agreement make sure that the agreement covers *at least* the following six critical topics:

1. **Standard of value**. Will the value be based on "fair market value" or "fair value" or some other standard. These words can have dramatically different interpretations. Some agreements simply specify "the value" of the company or interest. What's an appraiser to do then? Which value? The likelihood of a successful appraisal process diminishes greatly if this critical defining issue is not clear.

2. **Level of value**. Will the value pursuant to the buy-sell agreement be based on a *pro rata* share of the value of the business or will it be based on the value of an interest in the business? The differences bring minority interest and marketability discounts into potential play, and wide differences in interpretations of value. Two appraisers could agree regarding the value of a business, but if one applies a marketability discount, their conclusions can be significantly different, and confusion results. This is an issue that needs to be crystal clear in your agreement.

3. **The "as of" date for the valuation.** Believe it or not, some buy-sell agreements are not clear about the date as of which the valuation(s) should be determined by appraisers. This can be extremely important, particularly in corporate partnerships and joint ventures when events other than the death of a partner establish a valuation date. We were involved in major litigation a couple of years back where it took two arbitrations and several nationally known appraisers to resolve what was a dispute over the appropriate valuation date. Fortunately for our client, the arbitration panel agreed with our interpretation of the buy-sell agreement from a valuation viewpoint.

4. **The funding mechanism.** Many buy-sell agreements do not provide a specific funding mechanism, either through insurance, sinking funds, or pre-agreed payment terms. An agreement is no better than the ability of the parties and/or the company to fund any required purchases at the agreed upon price.

5. **Qualifications of appraisers.** Some buy-sell agreements provide a specific list of firms that the parties agree are mutually acceptable, either for a single appraiser option or for the multiple-appraiser options. In other cases, the specific, individual qualifications of appraisers are spelled out (e.g., credentials from a major credentialing organization, experience in appraisal, experience with the industry, etc.).

CONTINUED ON PAGE 2

Value Added

Remember this about buy-sell agreements: Someone will buy and someone will sell. You just don't know who that will be when you sign the agreement.

Credentials can be important. I reviewed a draft buy-sell agreement for an acquaintance a couple of years ago (actually, a good friend of a very good friend of mine). His company was a $100 million, highly successful service organization. The draft buy-sell stated that the appraiser should be an "accredited general appraiser" in the state of domicile. An accredited general appraiser is qualified to appraise residential or possibly small commercial real estate! This error was fixed in the next year!

6. **Appraisal standards to be followed.** Some buy-sell agreements go so far as to name the specific business appraisal standards that must be followed by any selected appraisers. For example, I have seen agreements that state that the appraiser(s) must follow the Uniform Standards of Professional Appraisal Practice and the Business Valuation Standards of the American Society of Appraisers.

What's so hard about specifying these things? Clients have told us that they have a hard time talking about some of these issues with their fellow shareholders when they are creating their buy-sell agreements. It makes people think about things they don't want to think about. But think about them you must.

The process of drafting a buy-sell agreement requires the parties to address important issues in balanced form at the outset. In doing so, they are forced to realize that each party could be a buyer – in the event of the death of a partner – or a seller. Actually, if one thinks about being a seller, it is actually his or her estate that will be the seller. This can be tough stuff to deal with.

You must understand that if these defining elements, including the pricing mechanism, are unclear in your buy-sell agreement(s), they will be the only thing you will be able to think about following a trigger event until the situation is resolved. Absent a clear agreement, this can take lots of money, lots of time, and create lots of hard feelings.

Remember this about buy-sell agreements: Someone will buy and someone will sell. You just don't know who that will be when you sign the agreement. Your agreement needs to work for you and your family whether you are the buyer or seller. And it needs to work for your partner(s) and their families (or their shareholders) whether they are the buyers or sellers.

Feel free to contact me with any questions you might have at 901.685.2120 or via e-mail at the address listed below.

Z. Christopher Mercer, ASA, CFA
mercerc@mercercapital.com

For Part One of this article, please visit our Article Library on the Mercer Capital website, found at www.mercercapital.com

DETERMINING LOST PROFITS DAMAGES

When an ongoing business is interrupted for whatever reason, it can be important to have a credible outside assessment of the lost profits associated with the business interruption.

This article is a basic primer on the subject of damages calculations for lost profits. It does not attempt to address the more technical aspects of damage calculations. It lists four basic steps – the lost profits of a business are determined by netting the lost revenue against the net cost savings associated with the business interruption and adjusting the result for the impact of mitigation. These lost profits are then brought to present value.

Step One. This first step is generally the most straight-forward: determining the amount of revenue lost. In most cases, this is done on an ***ex ante*** basis, with the lost revenue being calculated as the amount of revenue that would have been expected to have been received over the damage period at the time of the event that gave rise to the business interruption. However, jurisdictional practices vary widely, and it might be appropriate to calculate the lost revenue on an ***ex post*** basis, with the benefit of hindsight, for periods prior to the trial date.

This issue tends to come to the forefront when a triggering event causes an adverse impact on a number of businesses, or when there is another event that happens subsequent to the triggering event that would have had an impact on the subject business.

For example, if we suppose that a particular distributor of institutional food products would have recognized $2.0 million of revenue during a business interruption, it can be argued ***ex ante*** that the lost revenue of that distributor was $2.0 million. On the other hand, if we also know that the distributor's key restaurant customer, accounting for 50% of revenue, filed for bankruptcy protection during the damage period, it might be appropriate to consider the ***ex post*** impact of the bankruptcy on the lost profits associated with the business interruption.

Step Two. Having determined the revenue lost as a result of the business interruption, it is now necessary to determine the expense savings. During a business interruption, some expenses, such as rent, interest, and equipment leases, are likely to continue to be incurred. Others, such as sales commissions and, in certain cases the cost of products annually sold, will not continue to be incurred.

Once again, the calculation of expense savings can be performed either with or without the benefit of hindsight, although on the expense side, it has been our experience that ***ex post*** evidence is seldom ignored. These expense savings can be thought of as a form of mitigation of damages due to the lost revenue.

In addition to the expense savings associated with the business interruption, there might also be incremental expenses associated with the business interruption, such as expenses related to the rental of temporary facilities or the cost to fix whatever caused the business interruption. In our experience, these expenses are generally also considered damages, and their impact on the profitability of the firm is considered in the calculation of lost profits.

Lost profits for a given period are then determined by deducting the net expenses saved (expense saves less incremental expenses) against the lost revenue. For purposes of this discussion, we will ignore the case where the business interruption resulted in a new source of revenue.

Step Three. The final issue to consider is mitigation. In most states, the plaintiff bears some

CONTINUED ON PAGE 6

MERCER CAPITAL HIGHLIGHTS

SPEAKING ENGAGEMENTS OF NOTE

November 10, 2005
"Buy-Sell Agreements"
Firmwide Presentation:
Baker Donelson Law Firm
Z. Christopher Mercer, ASA, CFA

November 13, 2005
"Allocation of Enterprise Valuation to Various Classes of Equity"
FCG Seminar
Las Vegas, Nevada
Travis W. Harms, CFA, CPA/ABV

ARTICLES RECENTLY PUBLISHED

"Embedded Capital Gains, One More Time: *Estate of Jelke*," by Z. Christopher Mercer, ASA, CFA ***Valuation Strategies***, November/ December 2005

"An Appraiser's Focus on Buy-Sell Agreements," by Z. Christopher Mercer, ASA, CFA, ***Business Valuation Review***, Fall 2005

"Get Your BV Niche Out There," by Barbara W. Price, ***Journal of Accountancy***, November 2005.

This first step is generally the most straight-forward: determining the amount of revenue lost.

Value Added

In the tax world, personal goodwill can create significant savings to a taxpayer involved in the sale of a C corporation business.

An Overview of Personal Goodwill

In the world of FASB, goodwill is not delineated into personal goodwill and corporate or enterprise goodwill. However, in the tax world, this distinction can be of critical importance and can create significant savings to a taxpayer involved in the sale of a C corporation business.

Many sellers prefer that a transaction be structured as a stock sale, rather than an asset sale, thereby avoiding a built-in gains issue and its related tax liability. Buyers want to do the opposite for a variety of reasons. When a C corporation's assets are sold, the shareholders must realize the gain and face the issue of double taxation whereby the gain is taxed at the corporate level, and taxed again at the individual level when proceeds are distributed to the shareholders. Proceeds that can be allocated to the sale of a personal asset, such as personal goodwill, avoid the double taxation issue.

The Internal Revenue Service defines goodwill as "the value of a trade or business based on expected continued customer patronage due to its name, reputation, or any other factor."[1] Recent Tax Court decisions have recognized a distinction between the goodwill of a business itself and the goodwill attributable to the owners/professionals of that business. This second type is typically referred to as personal (or professional) goodwill (a term used interchangeably during tax cases).

Personal goodwill differs from enterprise goodwill in that personal goodwill represents the value stemming from an individual's personal service to that business, and is an asset owned by the individual, not the business itself. This value would encompass an individual's professional reputation, personal relationships with customers or suppliers, technical expertise, or other distinctly personal abilities which provide economic benefit to a business. This economic benefit is in excess of any normal return earned on other tangible or intangible assets of the company.

Personal goodwill differs from enterprise goodwill in that personal goodwill represents the value stemming from an individual's personal service to that business, and is an asset owned by the individual, not the business itself.

In ***Martin Ice Cream Co. v. Commissioner*** ("Martin")[2], the Tax Court ruled that intangible assets embodied in the shareholder's personal relationships with key suppliers and customers were not assets of the shareholder's corporation because there was no employment contract or non-competition agreement between the shareholder and the corporation. In this case, the shareholder/owner, Arnold Strassberg, had developed personal relationships with his customers over a period of approximately 25 years. During this time, Mr. Strassberg was instrumental in the design of new ice cream packaging and marketing techniques. In 1974, the founder of Haagen-Dazs (a large ice cream manufacturer) asked Mr. Strassberg "to use his ice cream marketing expertise and relationships with supermarket owners and managers to introduce Haagen-Dazs ice cream products into supermarkets."[3]

The underlying question in the Martin case involved the tax treatment of a 1988 split-off of Mr. Strassberg's portion of the business from the rest of the company. Arnold Strassberg had an oral agreement to distribute Haagen-Dazs products, and his portion of the business focused on the large supermarket customers, with whom he had developed personal relationships throughout his career. Arnold Strassberg's son Martin, the other shareholder of Martin Ice Cream Co. ("MIC"), preferred instead to focus on the small store business. Strassberg Ice Cream Distributors, Inc. ("SIC"), a subsidiary entirely related to Arnold Strassberg's side of the business that serviced the large supermarkets, was split-off from the rest of the company. Arnold Strassberg became the sole shareholder of SIC, and the assets of SIC were subsequently sold to Haagen-Dazs.[4]

The Tax Court held that Arnold Strassberg's oral agreement for distribution with Haagen-Dazs and his personal relationships with customers were never corporate assets of MIC, and therefore could not have been transferred to SIC in the split-off. Prior to the sale to Haagen-Dazs, Arnold Strassberg was the sole owner of those intangible assets because he had never entered into an employment or non-competition agreement. The Tax Court concluded,

> "Accordingly, neither any transfer of rights in those assets to SIC or other disposition to Haagen-Dazs is attributed to petitioner [Martin Ice Cream Co.]"[5]

While the Martin case does not provide specific methodology for valuing personal goodwill, it does lend guidance to the issue of identification of personal goodwill apart from corporate goodwill. Following the Tax Court's approach, the process of recognizing personal goodwill would consider the following issues:

- Do personal relationships exist between customers or suppliers and the owner/ manager of the business?
- Do these relationships (customer or supplier) persist in the absence of formal contractual obligations?
- Does the owner/manager's personal reputation and/or perception in the industry provide an intangible benefit to his business?
- Are the practices of the owner/manager innovative or distinguishable in his industry, such that the owner/manager is regarded as having added value to that particular industry?
- With respect to the above factors, is the owner/ manager currently under any employment agreement or covenant not to compete with the business?

The existence of personal goodwill apart from corporate goodwill was also recognized in *Norwalk v. Commissioner* ("Norwalk").[6] The Norwalk case centered on the tax implications of the liquidation and distribution of assets of an accounting firm (a C corporation). The two shareholders of the firm elected to terminate the company and to distribute its assets because the business was not profitable. The IRS maintained that the firm had realized a gain on the liquidation of its goodwill, and that the shareholders had realized a capital gain from the distribution of goodwill from their accounting firm to them. Although the shareholders had employment agreements with the firm prior to its dissolution, these agreements expired at the time of the liquidation.[7] The Tax Court found that the liquidation was not taxable because the employment agreements with the shareholders had expired. With no enforceable contract in place to restrict the activities of the accountants, any personal goodwill of the shareholders was not an asset belonging to the corporation. Therefore the distribution of the client base to the shareholders did not result in a taxable event to either the firm or the shareholders. Citing *MacDonald v. Commissioner*[8], the Tax Court in Norwalk stated:

> "We find no authority which holds that an individual's personal ability is part of the assets of a corporation by which he is employed where, as in the instant case, the corporation does not have a right by contract or otherwise to the future services of the individual."[9]

Although both Norwalk and Martin clearly recognize the concept of personal goodwill, neither provides a definitive answer as to its quantification. Because personal goodwill is considered to be the value of the services of a particular individual to a firm, the issue often arises in the context of professional practices. With respect to professional practices, *Lopez v. Lopez*[10] suggests several factors that should be considered in the valuation of professional (personal) goodwill:

- The age and health of the individual;
- The individual's demonstrated earning power;
- The individual's reputation in the community for judgment, skill, and knowledge;
- The individual's comparative professional success
- The nature and duration of the professional's practice as a sole proprietor or as a contributing member of a partnership or professional corporation.

Should a seller be contemplating an asset sale of his or her C Corporation, and there is a gain involved, the possibility of allocating a portion of the purchase price to personal goodwill should be considered. However, the idea must have a basis in reality. The best case scenario is when the shareholder/ manager has an excellent professional reputation and close contact with customers and suppliers.

While the transaction price, including intangible assets, is often negotiated between the buyer and seller, it is highly recommended that a professional appraisal be obtained to allocate the appropriate portion of value to personal goodwill.

Wendy Ingalls, CPA/ABV, CBA, ASA
ingallsw@mercercapital.com

Lucas W. Parris
parrisl@mercercapital.com

1 IRS Publication 535: *Business Expenses*, Ch. 9, Cat. No. 15065Z.

2 *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998).

3 Ibid.

4 Ibid.

5 Ibid.

6 *Norwalk v. Commissioner*, T.C. Memo 1998-279.

7 Ibid.

8 *MacDonald v. Commissioner*, T.C. 720,727 (1944).

9 *Norwalk v. Commissioner*, T.C. Memo 1998-279.

10 In re *Marriage of Lopez,* 113 Cal. Rptr. 58 (38 Cal. App. 3d 1044 (1974).

Value Added

It is highly recommended that a professional appraisal be obtained to allocate the appropriate portion of value to personal goodwill.

MERCER CAPITAL
5860 Ridgeway Center Parkway, Suite 400
Memphis, Tennessee 38120

VALUE ADDED

In This Issue...

Determining Lost Profits Damages

CONTINUED FROM PAGE 3

responsibility for mitigating damages. The company might have actually taken these steps, or it is conceivable that no steps were taken at all. The expert determines the financial impact of such mitigation.

Step Four. Once the lost profits associated with each period of the business interruption have been determined, it is generally necessary to bring those lost profits to the present for purposes of calculating an appropriate award.

In some jurisdictions, all periodic damages are discounted to present value as of the date at which the business interruption began, and then that amount may or may not be subject to prejudgment interest to the trial date. In others, expected periodic damages subsequent to the trial date are discounted to the trial date, and any damages related to prior periods may or may not be subject to prejudgment interest.

Because of the power of compound interest, jurisdictional differences in theories of recovery can have a significant impact on the actual amount of the award.

Conclusion. The expert in a lost profits damages analysis should have an in-depth knowledge of the company, their products, markets, and competition. An understanding of the subject company's industry is important. In addition, an understanding the economic forces that affect the financial outlook for the company are a must. The professionals of Mercer Capital provide damages quantification and expert testimony for clients throughout the nation. Call us in confidence at 901.685.2120.

BRENT A. MCDADE, CBA
mcdadeb@mercercapital.com