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Volume 2007-07 » July 31, 2007
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Recent Cases Highlight Problem Areas in Buy-Sell Agreements

by Guest Author, John Stockdale, Jr.

Permission to publish this guest article by John Stockdale, Jr., Editor, Business Valuation Resources is provided by Business Valuation Resources, Inc. www.bvresources.com.

The best time to think about what happens if the business or the relationship between the business owners doesn't work out is when the business is being formed and business owners are happy. While it is difficult to anticipate all the situations that might arise that may necessitate a buy-out, accounting for the situations you can predict such as death, divorce, and disability are necessary. One important component to an effective buy-sell agreement is the valuation clause. And depending on the parties, different situations may result in the use of different valuation mechanisms. Generally, a court will follow the operating agreement's valuation where the particular situation is clearly addressed and the valuation mechanism is clear and unambiguous.

Often death triggers a buy-out of the decedent's interest in the business entity. Early buy-sell agreements used book value to calculate the purchase price of the deceased's interest. Two recent probate cases emphasize problems associated with below market valuation provisions. In both cases the provisions were upheld despite that they provided for a price below the fair market value of the interests and the federal estate tax was levied on the fair market value of the stock.

In the *Matter of the Estate of Maurice F. Frink*, No. 6-433 (Iowa App. October 25, 2006), the Iowa Court of Appeals considered whether a buy-sell agreement that required the redemption of the decedent's stock at "book value" was ambiguous. The beneficiaries of the decedent's estate plan claimed that "book value" actually meant "fair market value," which would result in greater value for the beneficiaries. The court determined that "book value" was not an ambiguous term. It found that various dictionaries consistently noted the difference between "book value" and "market value." Furthermore, it noted that the company had consistently utilized "book value," as defined under generally accepted accounting principles, when it made prior redemptions. Thus, despite the considerable difference between "book value" and "market value," the court enforced the buy-sell agreement.

FEATURED TRANSACTION



Ohio County Bancshares, Inc.

Beaver Dam, Kentucky

Fairness opinion on behalf of
Ohio County Bancshares, Inc.
in its proposed acquisition by
Porter Bancorp, Inc.

Similarly, a California Court of Appeals considered whether a buy-sell agreement between two brothers regarding their businesses should be enforced against a trust holding those businesses and business interests. *Etienne v. Miller*, No. F049110 (Cal. App. 5 Dist. October 23, 2006), unpublished. The trust documents specifically referenced the obligations under the buy-sell agreement. The beneficiaries contested the enforcement of the buy-sell agreements because they provided for below market value prices and would, thus, create an onerous federal estate tax burden. The court found that the trustee should enforce the agreements, because the trust documents contemplated the purchase of the interests and, therefore, non-enforcement of the buy-sell provision would frustrate the purpose of the trust. In reaching this decision, the court rejected the argument that the trustee would breach his fiduciary duties to the beneficiaries if he complied with the buy-sell provision because it provided for below market values.

Z. Christopher Mercer in his book, *Buy-Sell Agreements*, addresses the benefits and drawbacks of using a formula buy-sell agreement, such as book value. While formula agreements are easy to use and understand, they have several drawbacks - particularly where the standard is book value. These drawbacks include the exclusion of any goodwill value from the calculation, the accounting method used by the company, which may include certain booked but unpaid liabilities, and the situation of the parties may have changed between the signing of the buy-sell agreement and the triggering event.

Similarly, the withdrawal of a member, partner, or dissention of a shareholder should be considered as an event triggering rights under a buy-sell agreement. Providing for this contingency early in the business' life may save the parties from costly breach of fiduciary duty or oppression claims by providing the parties with an exit mechanism. A recent Louisiana case illustrated how a formula buy-sell agreement worked well for the company.

In *Tynes E. Mixon, III, M.D. v. Iberia Surgical, LLC*, No. 06-878 (La. App. 3 Cir. April 18, 2007), the Louisiana Court of Appeals, Third Circuit considered whether a limited liability company (LLC) member was undercompensated when the LLC repurchased his interest upon his expulsion from the LLC. Mixon and other formed an ambulatory, out-patient surgical center in 1998. The operating agreement provided that a member could only be expelled upon a unanimous vote of the membership. In the event of expulsion or withdrawal, the member's interest would be repurchased at "fair market value" as computed under Exhibit E of the agreement. Exhibit E stated, "'Book Value' means the 'fair market value' ... of the net equity of the company." The remaining members unanimously expelled Mixon in 2002. The corporation's regular accountant calculated the book value of Mixon's interest under Exhibit E at \$71,357.

Mixon rejected this price and brought suit. He argued that the operating agreement required the repurchase of his interest at fair market value. He retained a CPA with valuation credentials to value his interest. The CPA valued the business using a comparable transaction method. Based on a 1989 sale of surgical center, he determined that the business should be valued at 9.89 times net income. This gave Mixon's interest a fair market value of \$483,100. The trial court granted the company's motion for summary judgment that dismissed Mixon's action. It reasoned that the terms of the operating agreement controlled and defined "book value" as "fair market value" of the net equity. Mixon appealed.

On appeal, Mixon argued that the terms "book value" are not synonymous with "fair market value." The appellate court agreed, but found that the parties agreed to use book value under Exhibit E of the agreement, which stated, "Book Value mean the 'fair market value' ... of the net equity." Further, "the book value of a business has a well defined meaning, is unambiguous, and is susceptible of only one construction. It is the value shown on the books of the business, and no other value. [Citation omitted]." Moreover, "good will, actual value or value in the open market, is not considered in determining book value." Since Mixon does not contend that the book value of his interest was improperly calculated and book value is the standard of value required under

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One of the reasons we wrote the book, *Buy-Sell Agreements*, was to help business owners and their advisors craft workable agreements. Examples of agreements gone wrong (and those that operated as planned) serve as a powerful reminder of what could happen to you.

Send your war story to Chris Mercer at mercerc@mercercapital.com and include your name. Once we receive it, we'll e-mail you your FREE copy of the 40-page "Buy-Sell Audit Checklist."

the operating agreement, Mixon received all that was due him under the agreement. Thus, the appellate court affirmed the lower court's grant of summary judgment in favor of the company.

While the above cases adequately illustrate the benefits and detriments of using of a formula valuation provision, such as "book value," in a buy-sell agreement, failure to address a possible triggering event, such as divorce, has its own repercussions. This is exemplified by *In re the Marriage of Barnes*, No. 2006AP3020-FT (Wis. App. May 17, 2007). The Wisconsin Court of Appeals considered whether the trial court erred when it valued the parties' interest in a limited liability partnership (LLP) under the withdrawal provision of the partnership agreement rather than the dissolution provision of the partnership agreement. During the marriage the husband and his parents established a LLP through which the husband operated a farming business. The husband contributed \$140,296 for a general partnership interest and his parents contributed \$300,000 for the limited partnership interest. The partnership agreement provided that in event a partner withdraws, the parents were entitled to a return of capital of \$250,000. However, in the event of dissolution, the parents were entitled to a return of capital of \$300,000. The partnership agreement did not provide a contingency for a partner's divorce.

The parties contested the valuation of the husband's general partnership interest. Both parties relied upon the partnership agreement as a guide to valuation. They treated the parent's contribution as a liability. The wife argued that the LLP should be valued under the withdrawal contingency while the husband argued that the LLP should be valued using the dissolution contingency and a liquidation analysis. The trial court adopted the wife's position and valued the business as if a partner had withdrawn. The husband appealed.

On appeal, the husband argued that the trial court erred when it used a liquidation analysis and did not value the LLP under the dissolution provision. The appellate court disagreed. It found that the trial court did not err when it selected one contingency over the other as a basis for the valuation when the partnership agreement "quite simply did not make any provision for valuation in the event of divorce." Thus, it affirmed the trial court's valuation of the LLP under the withdrawal provision.

Another area where the valuation provision needs to be considered is for estate planning purposes. The purchase price called for in a buy-sell agreement may, under certain circumstances, establish the fair market value of the interest for federal estate tax purposes. The factors include the following: (1) the price must be fixed and determinable under the agreement; (2) the agreement must be binding in life and death; (3) the agreement must have a bona fide business purpose; (4) the agreement must not be a testamentary device; and (5) the agreement must be similar to those entered into at arm's length. *Estate of Blount v. CIR*, T.C. Memo. 2004-116 (citing *Estate of Lauder v. CIR*, T.C. Memo. 1992-736; I.R.C. § 2703).

The cases and issues discussed here emphasize the complexity of buy-sell agreement. Many factors should be addressed in the buy-sell agreement: trigger events, purpose, and valuation method just to name a few. Important in this is consideration of what the ultimate purpose of the buy-sell will be, and explaining the importance of this document to the clients at the time it is drafted. For more information on buy-sell agreements in the business appraisal context and teleconferences on this issue, visit Business Valuation Resources' website: www.bvresources.com. You can also purchase a copy of Mercer's book, *Buy-Sell Agreements*, through Business Valuation Resources or on Mercer Capital's website: www.mercercapital.com.

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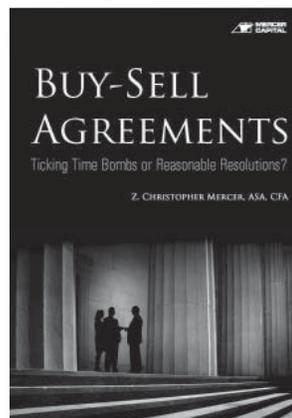
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BUY-SELL AGREEMENTS

TICKING TIME BOMBS OR REASONABLE RESOLUTIONS?

Released in January 2007, *"Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?"* has quickly become a valuable tool for attorneys, business advisors and business owners who recognize the importance of buy-sell agreements. Don't take our word for it. Below are just some of the published reviews of *"Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?"*.

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In the teacher's manual to our *Business Associations* case book, my friend, colleague and coauthor Bill Klein posits that "any lawyer who advises people entering into a business venture and who fails to urge the adoption of a buy-sell agreement is guilty of malpractice." Z. Christopher Mercer's new book *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions* offers a tremendously useful guide to these remarkably important contracts. In it, he provides guidance for business people and their financial advisors to use in assessing the need for a buy-sell agreement and, if one is appropriate, deciding on key terms. It will also be very useful to counsel drafting buy-sell

provisions, as it offers drafting checklists and samples of how various issues can be treated. I recommend it very highly.

STEPHEN BAINBRIDGE

*William D. Warren Professor of Law, UCLA
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In this eminently well-written, concise, and non-technical book, Chris lays out the fundamental parameters and processes that must be considered to minimize problems...Appraisers who read this book and apply its lessons will be able to position themselves in the marketplace as not just valuation specialists but in the wider role of facilitators of business valuation dispute resolutions, a much more productive role for us.

RAND M. CURTISS, FIBA, MCBA, ASA, ASA

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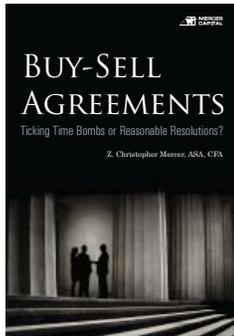
Mr. Mercer has done a great job of addressing the reasons business owners might want to have a buy-sell agreement and the business factors these business owners should consider in the agreement... Overall, Mr. Mercer provides valuation practitioners, business consultants, and business owners with a very useful handbook for preparing, reviewing and interpreting buy-sell agreements.

DAVID A. ELLNER, CPA/ABV

*The Financial Valuation Group
Published in the AICPA ABV e-Alert
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