

What Every Estate Planner Should Know About Buy-Sell Agreements

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Three Questions to Ask Yourself

1

Does my client have a buy-sell agreement?

If so, what type of agreement is it?

2

Do he know what it says?

There are 6 defining elements that must be in every process agreement if the valuation process and, therefore, the agreement, will work

3

How is the buy-sell agreement funded?

How life insurance proceeds are treated can make a big difference in the valuation of the company

Bonus Question



What would happen to my client's estate plan if their company's buy-sell agreement was unexpectedly triggered?

My client

Another shareholder

Types of Buy-Sell Agreements

Based on how the price is determined



Fixed Price
Agreements



Formula
Agreements



Process
Agreements

Fixed Price Agreements

The owners agreed on a price.

That price is likely years out of date.

There are three possibilities regarding the price set:

- The value today is lower, perhaps far lower, than the realistic value.
- The value today is higher, perhaps far higher, than the realistic value.
- The value is the same as it was back then.

Realities Seldom Discussed

- If the value is unrealistically low, each owner is betting that the other guy will die first and they will get to buy at the low price.
- If the value is unrealistically high, each owner is betting that they will be the one to leave the business so he/she and their family can benefit.
- The other owner(s) are making just the opposite bets.

Why should the owners take a chance that they'll be on the wrong end of that bet?

The owners haven't agreed on a way to update the price

Fixed Price Agreements

Advantages

- Easy to understand, easy to negotiate – the first time only!
- Inexpensive
 - Easy for attorneys to draft
 - No appraisers required

Disadvantages

- Fixed prices are seldom updated. Inequities are almost certainly a result of out-of-date fixed-price agreements
- The longer period of time between updates, the greater the potential for a divergence of the interests of the various parties
- Easy to set an initial price, but may be difficult to reset as time passes and interests diverge
- The normal procedure to address this problem is a flawed process agreement
- Betting that the other guy(s) will die first!

How to “fix” an out-of-date fixed-price agreement?

Update it annually – so simple but rarely ever done

Formula Agreements

The owners established a formula to calculate price.

Chances are, no one has calculated it lately.

Chances are, it can give an unreasonable result now.

Combined with changes in the company and the industry:

- The formula price may be higher than a realistic value today.
- The formula price may be lower than a realistic value today.
- The formula price is realistic today.

The owners haven't agreed on ways to make necessary/appropriate adjustments

Realities Seldom Discussed

- If the value is unrealistically low, each owner is betting that the other guy will die first and they will get to buy at the low price.
- If the value is unrealistically high, each owner is betting that they will be the one to leave the business so he/she and their family can benefit.
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Why should the owners take a chance that they'll be on the wrong end of that bet?

Formula Agreements

State a single formula to be applied to balance sheet and/or income statement metrics

Example

Multiple of EBITDA – (5 x EBITDA)

- Less debt?

Book Value

- “Shareholders’ equity per the audited financial statements at the end of the fiscal year immediately preceding the valuation date.”

How to “fix” a formula agreement?

Every year, calculate the price based upon the formula

Process Buy-Sell Agreements

The owners agreed to let business appraisers set the price for the agreement if and when it is triggered.

No one has the foggiest idea what will happen or what the price will be.

No one knows what “kind of value” the appraiser will provide:

- The value of an illiquid interest?
- The value of the entire enterprise pro rata to ownership?
- Reasonable and what each owner thought they agreed to?
- Not reasonable and what each owner thought they agreed to?

No one will know until the end of a lengthy & uncertain process what the outcome will be

Realities Seldom Discussed

- Each owner is betting that the ultimate price will be favorable (or at least reasonable) for them.
- The company is betting that the process will work and that the price set will be affordable.

**Everyone is betting
and someone will lose.**

Valuation Process Agreements

Multiple Appraiser Agreements

Multiple appraiser agreements call for the selection of two or more appraisers to engage in a process that will develop one, two, or three appraisals whose conclusions form the basis for the final prices.

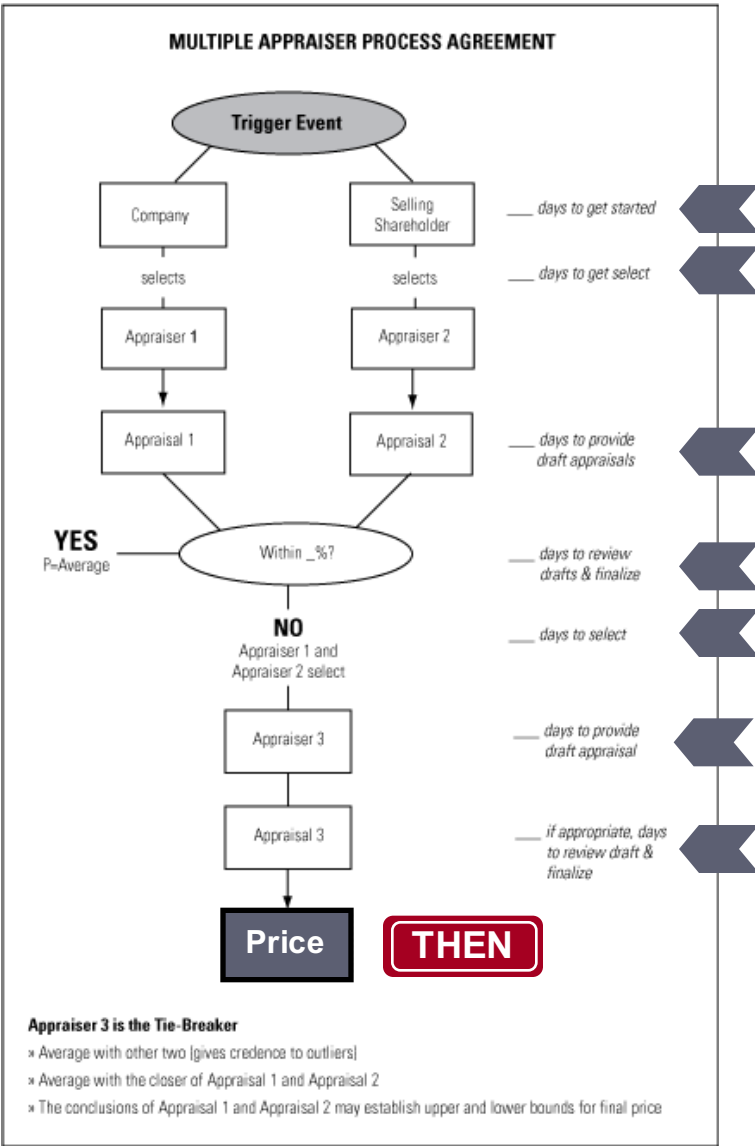
If that process sounds time consuming, cumbersome, and expensive, it is. Such processes can also be divisive and foster litigation.

- Third Appraiser as **Reconciler**
- Third Appraiser as **Determiner**
- Third Appraiser as **Judge**
- Third Appraiser as **Mediator**

Single Appraiser Agreements

Single appraiser agreements call for the selection of one appraiser whose appraisal conclusion forms the basis for the final price.

- Single Appraiser, **Select & Value at Trigger Event**
- Single Appraiser, **Select Now & Value at Trigger Event**
- Single Appraiser, **Select Now & Value Now**

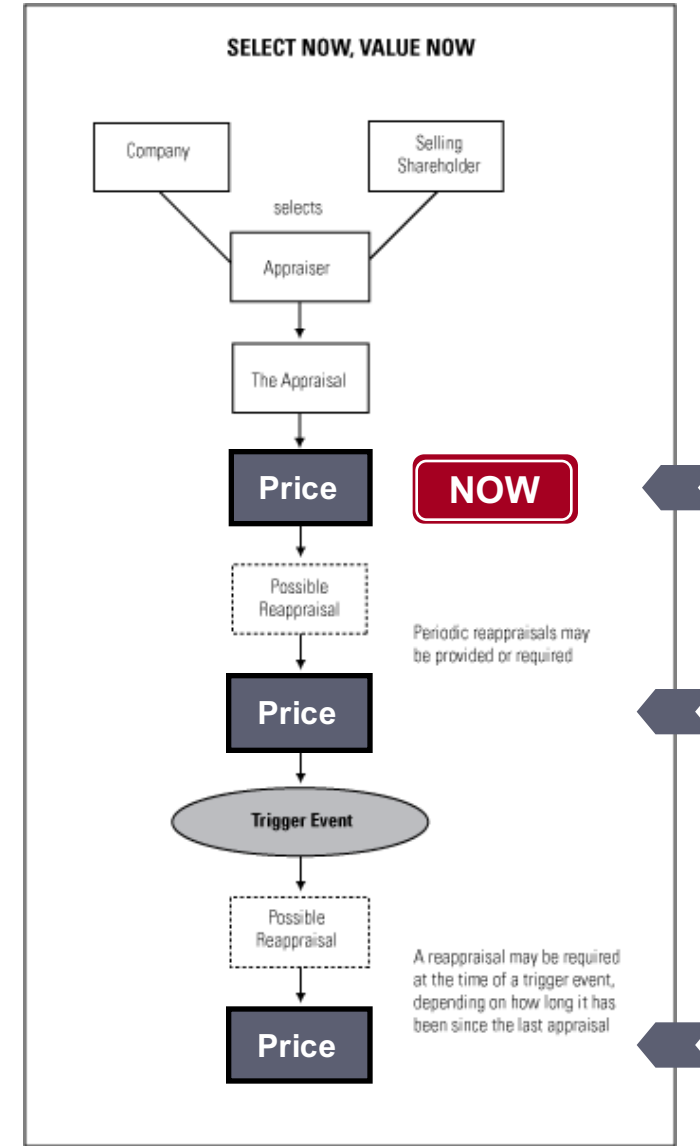


Multiple Appraiser Agreement

Recommendation

Single Appraiser Agreement

Select Now, Value Now



Advantages of a Single Appraiser – Select Now & Value Now Process vs. a Multiple Appraiser Process

Advantages	Single Appraiser – Select Now & Value Now	Multiple Appraiser Process
Price determined now	X	
Potential for satisfaction with the process for all parties	X	
Danger of advocacy	Minimized	
Certainty over what will happen when a trigger event occurs	X	
Certainty over final price if the process is invoked	X	
Issues with the aspects of the operation of the agreement are understood now and not deferred until a trigger event	X	
Cost effective	X	
Not time consuming	X	
Not distracting for management	X	
Not potentially devastating for affected shareholders and families	X	

Excerpt from Client's Buy-Sell Agreement

ARTICLE III.

Determination of Purchase Price

3.1. Purchase Price. Except as provided in Section 2.2(d), the purchase price of all Shares sold pursuant to this Agreement shall be the fair market value as determined by written appraisal of Mercer Capital Management, Inc., Memphis, Tennessee. The appraisal shall be made on the same basis as historically performed since 19xx, i.e. valuation of a minority interest without marketability. It is the Corporation's intent to create a mechanism to purchase its stock at fair market value, but not to create a mechanism which affects determination of fair market value; therefore, the purchase obligation herein should be ignored and not be considered in determination of fair market value. If the Corporation's fiscal year has ended, but the appraised value has not been determined, the Corporation may, at its option, delay a purchase for up to ninety (90) days from delivery to Corporation of its annual audit pending receipt of the appraised value. Corporation covenants and agrees that it will cause such appraisal to be made annually, and the value reflected by the most recent appraisal shall be used as the Purchase Price. If Corporation shall, in its sole discretion, determine that an appraisal should be updated to a more recent date, it shall notify Shareholders of such determination and provide results of the appraisal within one hundred twenty (120) days following the alternate valuation date.

Fixed Price Agreements

Estate of Claudia L. Cohen, by its Executor Ronald O. Perelman v. Booth Computers and James S. Cohen at A-0319

and

DeMatteo v. DeMatteo Salvage Co., 2011 NY Slip Op 09586 (2d Dept Dec. 27, 2011)

Estate of Claudia L. Cohen v. Booth Computers

Claudia Dies and Paragraph 16 is Invoked

The story is somewhat long and complicated, but we'll shorten it to focus on the relevant issue for this presentation, which is the Booth Computers partnership agreement and the buy-sell agreement therein.

1. Claudia Cohen died on June 15, 2007.
2. In July 2007, an attorney sent a letter on James' behalf implementing the buyout of Claudia's partnership interest for an amount of \$177,808.50.
3. Claudia's estate objected to the buyout, suggesting that the true value of the partnership, \$11,526,162, vastly exceeded its book value.
4. The trial court concluded that the buyout price of net book value (with a small adjustment), as called for in the partnership agreement, was the price that the parties had agreed to and was appropriate in the matter.
5. Claudia's estate appealed.

Paragraph 16

The death of a partner was a trigger event for purposes of the partnership's buy-sell agreement

16. The purchase price of any part or all of a Partner's interest in the Partnership shall be its value determined as follows:

- (A) Each of the Partners has considered the various factors entering into the valuation of the Partnership and has considered the value of its tangible and intangible assets and the value of the goodwill which may be present. With the foregoing in mind, each of the Partners has determined that the full and true value of the Partnership is equal to its net worth plus the sum of FIFTY THOUSAND (\$50,000) DOLLARS. The term "net worth" has been determined to be net book value as shown on the most recent Partnership financial statement at the end of the month ending with or immediately preceding the date of valuation;*
- (B) The value of any interest in the Partnership which is sold and transferred under the terms of this Agreement shall be determined by multiplying the full and true value of the Partnership as above determined by that percentage of the capital of the Partnership which is being sold and purchased hereunder.*

Paragraph 16

The death of a partner was a trigger event for purposes of the partnership's buy-sell agreement

The partnership agreement is clear that book value plus \$50,000 is the price at which partnership interests would trade hands under the agreement.

We learn in the case that Michael Cohen, brother to James and Claudia, died in June 1997.

James and Claudia invoked the partnership agreement and “Michael’s estate was paid \$34,503.08 for his one-third interest in Booth based on the formula in paragraph sixteen of the partnership agreement.”

Appellate Court Rules

The New Jersey Appellate Division noted the following:

We recognize the disparity between net book value and fair market value, yet the controlling factor as to which buyout method is applicable is the language of the partnership agreement. [going on to quote a treatise]...

...The trial judge's determination that Claudia's shares should be bought out at book value, rather than at fair market value, was supported by both substantial credible evidence and the applicable law. The judge did not err in holding that defendants established their entitlement to specific performance of the buyout provision as a matter of law.

Appellate Court Rules

Claudia's estate argued, among other things that the trial judge erred because he should have determined that the buyout price was unconscionable given the "gross disparity" between net asset value and fair market value.

Basically, the estate argued that the result of the judgment was that James obtained sole ownership, through Booth, of an asset worth vastly more than the price received by the estate.

Appellate Court Rules

The Appellate Court concluded:

Disparity in price between book value and fair market value, where a buyout provision is clear, is not sufficient to “shock the judicial conscience” and to warrant application of the doctrine of unconscionability. This view is consistent with the basic principle that where the terms of the contract are clear, it is not the court’s function to make a better contract for either of the parties.

Fair Warning to All

This case, *Estate of Claudia Cohen v. Booth Computers*, should be a clarion call to every business owner who has a buy-sell agreement with a formula pricing mechanism. The formula in this case was book value, an historical cost concept. Book value does not get adjusted as the market values of properties in a partnership rise. The formula in this case created a value that was only a small fraction of the fair market value of Booth's underlying assets.

If any partner wanted to obtain fair market value in a transaction, Booth's Paragraph 16 was, indeed, a ticking time bomb. While stated as a "formula," the Booth partnership agreement essentially called for a fixed price of book value.

Fair Warning to All

I have said for years that formulas and fixed prices are not good pricing mechanisms for most buy-sell agreements. Two short quotes from *Buy-Sell Agreements for Closely Held and Family Business Owners* state the conclusion succinctly:

Re Formulas (at p. 85)...My experience suggests that no formula selected at a given point in time can consistently provide reasonable and realistic valuations over time. This is true because of the myriad of changes that occur within individual companies, local or regional economies, the national economy, and within industries. Formulas simply cannot take into account these many factors in a meaningful and consistent manner.

Re Fixed Prices (at p. 80)...In my opinion, for most situations, fixed-price buy-sell agreements should be avoided like a contagious disease. However, if you have a fixed-price agreement, you must have the discipline to update the price periodically. And you must amend the agreement to include a workable appraisal process in the (likely) event that you fail to update it.

DeMatteo v. DeMatteo Salvage Co.

Introduction

DeMatteo Salvage Company, Inc. is a Long Island-based, family owned business since the 1920s, designing and installing machinery and equipment for scrap paper and solid waste customers. The company had multiple owners who, in this case, were brothers. DeMatteo Salvage also had a buy-sell agreement which dated back to 1966. It was a fixed-price agreement, which read, in part:

The last value established preceding the death of a Stockholder shall be the value of his stock for purposes of this agreement. This provision shall not be altered by the fact that the Corporation and the Stockholders for any reason have failed to predetermine such value at any time or from time to time. All redeterminations of value shall be endorsed upon Schedule A hereof, dated and signed by the Corporation and the Stockholders.

DeMatteo Salvage Co. and the DeMatteo families who owned it, were mired in litigation regarding their buy-sell agreement for nearly a decade.

From Peter Mahler's Blog

“Between the first buy-out litigation following the eldest brother Joseph’s death, and the second lawsuit started by Gloria after Edward’s death, the DeMatteo family has been warring in the courts over the value of the companies’ shares for more than a decade. Whatever one thinks of the outcome, what’s absolutely clear is that the buy-sell agreement failed miserably, both in its design and its implementation, in its intended purpose to ensure family control of the businesses while providing the shareholders’ heirs with a measure of financial security based on a consensual, non-litigated, fair valuation of the companies’ equity.

It was a mistake to design the buy-sell agreement without requiring periodic updates.

It was a mistake to design the buy-sell agreement without providing an alternative valuation method when a buy-out event occurs more than a year or two after the last agreed valuation.

From Peter Mahler's Blog

... It was a mistake for the shareholders to come up with their own valuations over the years without seeking the guidance of a professional appraiser.

It was a mistake for the shareholders to agree to rescind the prior valuations in favor of obtaining a professional appraisal, and then not following through by having the professional perform the appraisal until long after the death of a shareholder, when the financial interests of the surviving shareholders and the deceased shareholder's estate became antagonistic.”

Peter Mahler

An Ill-Fated Solution to an Ill-Fated Buy-Sell Agreement

Template Language Gone Bad

The Entire Buy-Sell Agreement

“Section 12.4 Option

If the controlling interest in a Partner or an Affiliate of a Partner which controls the Partner is sold to a third party, then the other Partner shall have the option to purchase the Partnership at its appraised value as a going concern. If the parties are unable to agree on an appraiser, one shall be appointed by the American Arbitration Association. The appraisal shall be completed within 90 days from the date of appointment of the appraiser. The other Partner shall exercise its option within 30 days of the appraiser’s report. Closing shall occur within 90 days from the date such option is exercised.”

117 Words

\$6,000,000

Conclusion

The Best Buy-Sell Agreement Pricing Mechanism

The parties should:

Select a single appraiser, agreeing on his/her qualifications and the standards under which appraisals will be rendered.

Have that appraiser provide an appraisal for purposes of the agreement. If there are problems or issues with the kind of value that the parties desire, they can be fleshed out while the appraisal is in the draft stage. Make sure there is agreement between the standard and type of value called for in the agreement and that obtained in the draft appraisal. When all this is clear —

Finalize the appraisal, which becomes the price for the agreement for the next period (year most likely).

After a year, have the selected appraiser reappraise the company to reestablish the purchase price for the agreement.

After another year...

Questions?

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Z. Christopher Mercer is the founder and chief executive officer of Mercer Capital. Chris began his valuation career in the late 1970s. He has prepared, overseen, or contributed to hundreds of valuations for purposes related to tax, ESOPs, buy-sell agreements, and litigation, among others. In addition, he has served on the boards of directors of several private companies and one public company. He enjoys working with business owners to address ownership transition issues.

Chris has extensive experience in litigation engagements including statutory fair value cases, divorce, and numerous other matters where valuation issues are in question. He is also an expert in buy-sell agreement disputes.

Chris is a prolific author on valuation-related topics (authored or co-authored eight books) and a frequent speaker on business valuation issues for national professional associations and other business and professional groups.

About Mercer Capital

Mercer Capital is a national business valuation and financial advisory firm.

We offer a broad range of services, including corporate valuation, financial institution valuation, financial reporting valuation, gift and estate tax valuation, M&A advisory, fairness opinions, ESOP and ERISA valuation services, and litigation and expert testimony consulting.

We have provided thousands of valuation opinions for corporations of all sizes in a wide variety of industries. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement.

Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation in connection with engagements involving their clients.

For over 35 years, Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies and financial institutions located throughout the world. Feel confident in our experience and expertise.

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