KTS VALUATION ISSUES™

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Buy-Sell Agreements

By Brad Bollinger, ASA

Throughout my tenure at KTS as a valuation consultant I have worked on several valuations for the purpose of determining an appropriate purchase price of common stock, as required by a buy-sell agreement. I have come to realize that these agreements are a vital tool in the succession planning of a closely-held business. Disagreements among family members or old friends can tear apart a business, as has been the case in some of our assignments where a buy-sell agreement has not been installed. In these instances, good judgment and shrewd business skills are cast aside in favor of spite or revenge, which has led me to strongly believe in the need for these agreements.

Within a closely held business there are many concerns regarding the continuation of the business upon the death or departure of a shareholder. Can the remaining owners avoid taking on an unwanted party as a shareholder? Will the remaining shareholders have the economic resources to purchase the departing owner's interest? One way to mitigate many of these concerns is for the shareholders to enter into a buy-sell agreement. The following article will first define the purpose of a buy-sell agreement and describe the various components of a typical agreement. It will discuss the transfer restrictions, valuation provisions, and funding methods of a buy-sell agreement, and describe the different types of agreements. Finally, it will present the potentially huge cost of taking on an unwanted shareholder, and describe how a buy-sell agreement can help to avoid this outcome.

Within a closely held business there are many concerns regarding the continuation of the business upon the death or departure of a shareholder.

A buy-sell agreement details what is to occur upon the departure of one of the owners of a business. It allows the owners to provide a framework for the smooth transfer of ownership under certain triggering events, while continuing the operation of the business. For the business entity, a buy-sell agreement can help accomplish several goals, including the following:

- Allows for a smooth transition in the control of the entity;
- Permits the owners to begin transferring ownership and control of the business before the triggering event;
- Provides liquidity for the ownership interest;
- Prevents the ownership interest from being sold or otherwise transferred to unwanted parties;
- Provides an independent mechanism for determining a price or pricing formula for the business interest, decreasing the potential for disputes;
- Establishes a valuation of a deceased owner's interest in the business for estate tax purposes.

There are many types of triggering events that will cause a mandatory or optional buyout pursuant to the terms of a buy-sell agreement. These include an owner's death, disability, termination, retirement, desire to sell the interest to a third party, divorce, bankruptcy, and others. Upon one of the triggering events, the transfer of the subject interest will take place subject to the terms and conditions of the agreement.

A typical agreement will specify transfer restrictions, valuation provisions, and

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funding method to be used. Typically, the restrictions on transfer include a right of first refusal where before transferring shares to any outside party, they first must be offered to the company and/or the other shareholders (Pratt, 2000). The price at which they are offered is sometimes defined by the agreement in terms of a stated purchase price or a formula for determining the purchase price. Other times, the agreement requires an independent outside appraisal to determine the purchase price. It is in these instances KTS is often hired to provide an independent opinion of the fair market value for the subject common stock.

A buy-sell agreement many times is funded with life insurance. Upon the death of a shareholder, his/her interest is purchased with the proceeds from the life insurance. There are several advantages in using life insurance to fund the agreement. First, the deceased shareholder's estate gets paid in cash, eliminating the need to rely on the corporation's continuing prosperity. Second, the company's investment in the cash value of an ordinary life policy is a business asset. Third, any excess insurance the corporation carries over and above the value of the stock purchase agreement can be retained as earned surplus (Pratt, 2000).

There are three main types of buy-sell agreements: cross-purchase agreements, redemption agreements and hybrid agreements. Each type of agreement may be binding on both parties or optional for one party, usually the purchaser. Below is a description of each type of agreement.

Cross-purchase agreements allow one or more other shareholders, entities or individuals to purchase shares upon a triggering event, such as death. The purchase is typically funded by life insurance. Each shareholder of a corporation purchases an insurance policy on the other shareholders. The purchaser is both the owner and the beneficiary of the policy. Then, upon the death of a shareholder, the other shareholders are able to use the life insurance proceeds to purchase the deceased owner's shares (Joy, 2004). A cross-purchase agreement becomes very difficult to implement with a large number of shareholders. In addition, for owners of different ages and health profiles, young owners may be forced to pay very high, disparate premiums to cover older owners. In situations with a large number of shareholders of different ages, a redemption agreement may be more appropriate.

Redemption agreements allow for the business to purchase the interest of the departing owner. The business is responsible for financing the purchase, which may be funded by the immediate use of the business's resources, a financing arrangement defined by the agreement, remaining owners' personal savings or life or disability insurance on the life of the departing owner (Burrage, 2004). Redemption agreements are easier to administer for large numbers of shareholders or shareholders of different ages and health profiles.

The agreement acts as a succession plan that eliminates the potentially huge cost of taking on an unwanted shareholder.

Hybrid agreements can be drafted to allow both the company and the other shareholders the opportunity of waiting until after the date of death to determine which is in better tax and liquidity condition (the company or the other shareholders) to purchase the shares. They usually allow the issuer first priority to buy the interest and the other stockholders or partners the second-place option to buy. (Pratt, 2004)

The shareholders in a closely held business are vulnerable to the potentially huge cost of taking on an unwanted owner. In the event of the death of one of the owners, the surviving owners will want to ensure the continuity of ownership and management without having the departing owner's successor forced upon them. An unwanted owner can cause significant problems and eventually tear a business apart. A buy-sell agreement can avoid this problem.

For example, Tom and Jim are equal owners in a closely held corporation in which they own all the stock. They are both in their early 50s and in good health. They have both worked in the business for most of their adult lives, and both are strong contributors to the success of the business. Each of them expects to work in the business for at least another 10 years, and they have an informal agreement to sell the business to fund their retirement. There is no buy-sell agreement in place.

The above situation will work out fine if both Tom and Jim are able to remain in the business until retirement. But lets assume Tom dies unexpectedly. Now Tom's heirs need to liquidate the business interest to pay expenses and taxes. However, Jim cannot afford to buy Tom's share at fair market value, and he refuses to sell. Tom's heirs are forced to seek an outside investor whom Jim does not approve of. There is a very limited market for this particular business interest, and the only option for Tom's heirs is to sell to a competitor whom Jim will not work with. Now Jim is forced to take on an unwanted partner, or sell his portion of the business before he is ready. If Tom and Jim had a properly funded buy-sell agreement in place, there would not be any problem. Jim could afford to buy Tom's share of the business with the life insurance proceeds, or the Corporation would buy the interest.

In conclusion, a buy-sell agreement provides for the smooth transition in the control of a business. It limits the universe of potential buyers, and provides liquidity for the interest. The agreement acts as a succession plan that eliminates the potentially huge cost of taking on an unwanted shareholder. As we can see above in the example with Tom and Jim, the buy-sell agreement should be a necessary part of any closely-held business. ❒

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Partitioning

By John A. Thomson, ASA, MAI

Real estate law provides a remedy for the owner of an undivided interest in real property. This is known as partition. The real estate owner of a fractional interest has the right to become whole in ownership, or his right to a pro-rata portion of the full fee or leased fee value.

Partition is a device recognized and regulated by law for changing undivided interests into several and exclusive interests proportionate to the former undivided shares. Because of the obvious practical difficulty of making an equitable division of most real estate, the usual consequences of a partition suit is instituted by a co-owner of real property in a sale of the property by order of the court with each co-owner receiving a share of the proceeds equivalent to his undivided interest in the property. Some appraisers, including Klaris, Thomson & Schroeder, Inc. ("KTS"), use partitioning cost (or more appropriately partition cost "plus"1) as a measure of the discount applicable in a certain undivided interest. The IRS is also a strong supporter of partitioning cost as the measure of the discounts applicable to certain undivided interests (TAM 9336002). This article is not presented to analyze how to arrive at the discount for an undivided interest, but to summarize the results of two cost surveys, 1997 and 2006, relative to legal cost and what various attorneys encounter relative to duration of the process.

In addition, KTS added certain related cost, such as referee and appraisal fees, to the legal cost. There are two stages, or types of partitioning cost, contested (contested and possibly a trial) or uncontested. In the 1997 survey, relative to uncontested cost, KTS added $5,000 to $10,000 to the legal fees for other related cost. Relative to contested partitioning, KTS added $15,000 to $20,000 for other related cost.

In 1997, our survey indicated that the legal cost ranged from $1,000 to $30,000 for a partition action uncontested and/or a total cost of $6,000 to $40,000.

When the partitioning was contested, the legal cost was reported at $5,000 to $100,000, or $20,000 to $120,000 for the total costs. The average time frame for a partition was a few weeks to 6 months uncontested and six months to two years, if contested.

Partition is a device recognized and regulated by law for changing undivided interests into several and exclusive interests proportionate to the former undivided shares.

In our 2006 update of the partitioning cost survey, the cost was reasonably similar. The uncontested legal cost ranged from $1,000 to $25,000 (adding $6,000 to $12,000 for non-legal cost). The total cost ranged from $7,000 to $37,000 for uncontested partitioning action.

If the partition action was contested the legal cost ranged from $5,000 to $250,000 or $23,000 to $275,000 for total cost (adding $18,000 to $25,000 for non-legal related cost). The time of the partition action again was very similar, one to six months for an uncontested partition action and one to three years for a contested partition action.

The feedback from the survey indicated that the vast majority of partition actions were non-contested. For those that were contested, the majority settled before trial, as the recognition of the cost became more apparent.

An interesting point to consider is that if only 10-20 percent of partition actions are contested, and 50-70 percent of these are settled before a trial, is it reasonable to focus the entire portion of cost and time on those that do not settle? Basically, three to ten percent of all partition actions[2] go to trial where the heavier costs are. More importantly, if the time involved in the contested partitioning actions, which go to trial (three to ten percent of the total partition actions), is one to three years with possibly the unusual exception reaching four years, is it reasonable to use one to three years or more as the average or "norm" for all partition actions? We believe that the upper end of the time range (three years) should be treated as the exception (the outlier or aberation) and not the norm (average). We have seen some appraisal firms engineer a discounted cash flow using a time period of three to five years or more to establish their undivided interest discount which was in excess of three times the undivided interest discount of 15 percent rendered by the court in the Propsta and Moneyham cases. ❐

[1]The "plus" refers to any incremental increase in the discount rate over and above partitioning cost to account for these elements of minority and marketability not covered by the partitioning cost alone.

[2]30 percent of 10 percent equals 3.3 percent; 50 percent of 20 percent equals 10.0 percent.

NEWS & NOTES

Klaris, Thomson & Schroeder, Inc. is celebrating 15 years in business: 1993 - 2008!

The Los Angeles office of Klaris, Thomson & Schroeder, Inc. ("KTS"), proud recipient of the 2006 Alfred P. Sloan Award, has also been selected as an honorable mention for the 2008 Alfred P. Sloan Award for Business Excellence in Workplace Flexibility in the greater Long Beach area!

Congratulations Brad Bollinger of the KTS St. Louis Office in receiving his MBA and just recently his ASA designation on May 1, 2008!

Congratulations again to Brad Bollinger who is the proud father of Nathan Bradley Bollinger born August 11, 2008 at 1:45 p.m.!

Klaris, Thomson & Schroeder, Inc. welcomes the submission of related articles from our readers.

Please contact Anita Thomson at 877-587-7008.

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– Charles Darwin

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