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Valuation Aspects of Buy-Sell Agreement Disputes

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Whenever a shareholder dispute occurs, one of the first questions legal counsel and the forensic accountant will ask is whether or not there is a Buy-Sell Agreement (also referred to as a Shareholders' Agreement) in place. The existence of a Buy-Sell Agreement will often be the blueprint for a resolution of any concerns and any dispute with regard to a departing shareholder. This would normally be true whether the shareholder has been "fired" or has left of his/her own volition. Even death or permanent disability can be a trigger for dispute if the terms and conditions for payment of the stock are not clearly set out.

Some of the issues that can lead to disagreements under the terms of a Shareholders' Agreement can include the determination of a price to be paid, as well as the timing of the payment. In some cases, even the requirement of the company to buy the stock may be a fact in dispute.

Funding is one aspect of a Buy-Sell Agreement that can often be disputed. When life insurance is in place, and a shareholder dies, it would ordinarily appear that the funding mechanism would be simplistic; the company would apply for the insurance proceeds once a death certificate has been obtained; the insurance company will pay the proceeds; the company uses the proceeds to buy the stock, and all parties move on. Unfortunately the terms of Buy-Sell Agreements as well as other understandings, written or otherwise, can obfuscate the original intent.

In some cases, the life insurance is held by a legal entity other than the corporation. This may be done for tax purposes, or for other reasons. When this occurs, it is important to coordinate all agreements to understand whether or not there is a <u>requirement</u> for the purchase of the stock of the deceased shareholder with the proceeds of the life insurance policy.

If the agreements are unclear, and if they were generally written by counsel for the corporation, the ambiguity would ordinarily be determined in favor of the deceased shareholder. In at least one circumstance we have seen, the full life insurance proceeds went to the estate, and the estate also was able to collect a significant sum in exchange for the sale of the stock back to the corporation. With the exception of the executor of the estate (the widow of the deceased), all parties were under the impression that the life insurance proceeds were <u>*specifically*</u> intended to make the payment for the corporate stock.

For this reason, it is always important to understand the beneficiary and owner of any life insurance policies, as well as any agreements that are in place.

There are a variety of other triggering events that may apply to shareholder Buy-Sell Agreements, including:

- Permanent disability
- Event of personal bankruptcy
- A matrimonial property claim under a divorce agreement
- The intent to sell the shares on the open market
- Felony criminal conviction
- Termination of employment with the company (voluntary or involuntary)
- Normal retirement age or
- A deadlock or stalemate among the shareholders on a critical (usually delineated) issue

A forensic accountant will assist in understanding the financial aspects of the terms of the Buy-Sell Agreement and assist in putting them forth, initially to the parties, and potentially later to a Court or arbitration panel. The use of arbitration in Shareholders' Agreements is still gaining in popularity, although attorneys will often have different views on whether this is beneficial, and if so, for which party.

Different jurisdictions may have different requirements with regard to the enforceability of a Shareholders' Agreement, and this obviously becomes critical if shareholders have moved to a different jurisdiction from the time the Agreement was executed. Normally the Shareholders' Agreement itself will call for a determination of law in a specific jurisdiction.

In some circumstances it will be important to understand whether or not the triggering event is clearly defined and understood, and agreed to by all parties, and whether it is defined in the Agreement. Many times, the triggering event is deemed to be other than as defined in the Agreement, or the parties may not even agree as to whether a triggering event has occurred and/or what the date of the triggering event was. In addition, the agreement will need to be reviewed to determine whether there is a requirement for the purchase of the stock by the corporation under the deemed circumstances or only creates the opportunity to possibly purchase the stock.

In some circumstances, a valuation will be required, based on the terms of the Agreement, or the lack of an Agreement. The valuation itself can be complicated as to whether or not the Agreement or the law clearly states the methodology for valuation. Fair Market Value will normally be defined as the ability of a willing buyer and a willing seller, each being reasonably informed as to all circumstances with regard to the entity and each being able to consummate a hypothetical transaction, but neither being compelled to do so, and may also include a variety of appropriate discounts to be considered.

In other circumstances, Fair Value will be the determination, in which case, generally under State law, no discounts for lack of marketability and/or minority discount will be applicable. This very issue by itself can be a significant disagreement as the discounts for a minority position in an entity with a lack of marketability can range from a combined 35% to 60% (plus or minus).

In some cases we have seen Agreements that provide for the Buy-Sell price to be based on "book value", and this can be problematic in and of itself. For these reasons, it is important for the forensic accountant and/or valuation expert to not only be cognizant of the different methods of valuation, but also to be instructed by legal counsel on the appropriate methodologies for valuation that are deemed to be in place under the applicable state law and the Agreement.

When book value is defined in the Agreement, there are substantial issues that can arise. Generally book value does not take into account any aspect of goodwill. If a business has had a significant and regular experience of profitability and positive cash flow, the goodwill will not be reflected on a balance sheet. In addition, in certain types of entities, there may be long-term contracts in place that are not reflected in any facet of the financial statements. Still further, some entities keep their books on a cash basis of accounting, which doesn't even take into account accounts receivable and accounts payable, and therefore is even less likely to reflect any type of appropriate value. Nonetheless, many entities utilize book value, sometimes with specified adjustments, in their Buy-Sell Agreements.

In some cases, the setting of a price is deemed to have occurred in the Agreement itself. The terms of the Agreement will call for a purchase price under each specific type of event at either a total dollar amount and/or a dollar per share amount. In most cases, this is also accompanied by a schedule which is intended to be updated on a regular (usually annual) basis. In our experience, many entities neglect to timely and properly update their valuation page attachments to Buy-Sell Agreements. Then, when a triggering event occurs, an additional dispute arises as to whether the most recent valuation in place (which may be the one from the original signature date) is utilized, or a new valuation as of the date of the triggering event is required.

Even the date of the calculation may be subject to debate. In some triggering events, the date of the calculation as to the value is specific—it is the date of the event. If it is not specific, and if there is a drawn out period of time between the alleged triggering event and the date of attempted resolution by the purchase of the stock, an additional dispute may arise with regard to the valuation date. If a triggering event occurred on December 31, 2001, and no payment had been made or agreed to as of June 30, 2005, the valuation, whether it's Fair Market Value or Fair Value, could be dramatically different between those points in time.

In some circumstances, a Buy-Sell Agreement will call for the price to be determined by what is commonly referred to as a 'shot gun approach'. In a shot gun approach, the parties effectively bid against each other saying: "you cut the pie into two pieces and I will choose my slice" whereby each party effectively is making a bid on a total price or a price per share for the entire company. This is not the norm, but may evolve into a methodology based on negotiations for resolving the dispute. In addition, where there are two shareholders each owning 50% of the stock, this is not an uncommon approach for the written agreement. In a circumstance like this, if the prospective seller asks for too high a price, he will effectively become the buyer instead of the seller with the other party tendering all of their shares in response to the asked price.

One of the last areas that may be utilized for pricing is a *bona fide* offer. If a *bona fide* offer has been received from an independent third party, in many circumstances the prospective seller must first make an offer at the same price and terms to the other shareholders and/or the corporation. The other shareholders and/or corporation will then have a period of time in which to either accept or reject the offer. If the correct period of time expires without the offer being accepted by the shareholders and/or the corporation, the prospective selling shareholder is then free to make the sale to the outside third party.

The issues with regard to a Buy-Sell Agreement, once it falls into a potential dispute, are multiple. The forensic accountant can often help legal counsel in understanding the various aspects of the alternative conclusions.