

# VIEWPOINT ON VALUE

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Buy-sell agreements:  
How to cover all the  
(valuation) bases



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# Let's make a deal

## Customize M&A terms to fit your needs

Are you interested in selling (or buying) a business interest? The gap between how much the seller expects to receive and how much the buyer is willing to pay can be bridged by incorporating creative options into the purchase agreement.

### Earnouts

With an earnout, a portion of the sales price is typically withheld in an escrow account or paid from future operating cash flow — *only if* certain predetermined financial benchmarks are achieved. An earnout allows a seller with optimistic sales projections to achieve a higher selling price by bearing some risk that the business will perform as expected. On the flip side, an earnout lowers the risk that the buyer will overpay for a company that doesn't achieve its projections.

There are some disadvantages to earnouts, however. When the earnout is due, the parties may disagree about how to verify financial

performance. Earnouts also bring complicated tax issues to the negotiating table. For instance, will earnout payments be considered compensation for services or as additional sales proceeds? The buyer and seller have competing interests on this matter.

If earnout payments are treated as compensation, the seller reports them as ordinary income, which is taxed at a higher rate than capital gains. The seller also owes employment taxes on the income (or self-employment tax if not an employee of the seller). The buyer gets a deduction for any amount treated as compensation or the amount paid to the seller as consulting fees. To the extent any earnout payment is treated as compensation, the buyer will also be responsible for the payroll taxes associated with such payments.

If earnouts are treated as additional sales proceeds (not as compensation), the seller may qualify for (lower) capital gains treatment. But

### What's for sale: Assets or stock?

The answer will have important tax and legal implications:

**Asset sales.** Buyers often prefer asset sales, because specific assets to acquire can be selected. This option usually prevents buyers from inheriting contingent liabilities, such as product claims and employee-related lawsuits. But intellectual property, contracts, leases and goodwill may be difficult to assign or transfer in an asset sale.

From a tax standpoint, the buyer benefits from a stepped-up basis for any depreciable assets acquired. However, the seller typically owes more tax in an asset sale.

**Stock sales.** Here, the buyer acquires an equity interest in the company, requiring the seller to divest any unwanted assets and liabilities before closing. Any hard-to-assign assets automatically transfer to the buyer, along with contingent liabilities.

Sellers generally prefer stock sales for tax purposes, because stock sales usually result in a lower tax bill on the sale. But the buyer doesn't get a new basis for the company's depreciable assets; instead, the company's existing depreciation schedule still applies.

the buyer receives only an increased tax basis in his or her investment.

In addition, complex tax rules could apply if the earnout payment isn't made before year end. The rules differ depending on whether there's a determinable maximum selling price and/or a fixed payment period.

### Installment sales

Under the installment method of reporting the transaction, sellers of certain eligible property can recognize the tax gains or profits from installment sales proportionately over time. The installment method also gives the buyer a fully stepped-up basis in the acquired property. So, the buyer can take depreciation deductions based on the purchase price, even though the full amount wasn't exchanged at closing.

Installment sales can be advantageous in getting a deal done when the buyer has limited access to bank financing. In effect, the seller is financing the deal and bears some default risk.

Installment sales can also save tax for the seller if tax rates fall. Conversely, they can be costly if tax rates increase. Another tax consideration for sellers is that depreciation recapture must be reported as gain in the year of the sale — even if it exceeds the installment payment the seller receives that year.

Not all transactions are eligible for the installment method. For example, inventory sales and transactions involving related parties are ineligible.

### Consulting agreements and restrictions

After closing, the seller can serve as an employee or consultant to facilitate the change in management. The seller's continued



involvement with the business can reduce turnover, minimize disruptions, and build trust with long-term employees, suppliers and customers.

On the flip side, the seller could use his or her business contacts and specialized knowledge to start a competing business. If so, the buyer should consider adding restrictive covenants — such as noncompete or nonsolicitation provisions — to the purchase agreement that prevent the seller from: 1) diverting business opportunities from the company, 2) working for any competitors within a negotiated distance of the business, or 3) soliciting the company's employees to leave the business to work for the seller or any affiliated entity.

The parties should negotiate in advance how much of the purchase price to allocate to consulting agreements and restrictive provisions. These allocations will have tax and financial reporting consequences, so it's important to get the allocations right.

### Need help?

Negotiating the optimal deal structure takes time, patience and financial know-how. A valuation specialist can help you understand the financial implications of creative deal terms. ■

# Family businesses bring valuation challenges

Family-owned businesses aren't usually run like large public companies. From the Rockefellers to the Kardashians, working together can bring out the best — and worst — in families. Here are four key questions valuation experts ask when valuing these entities.

## 1. Are family members on the payroll?

The terms “family business” and “nepotism” often go hand in hand. Although some business owners hire family members because they're perceived as more trustworthy, many hire them out of obligation or to satisfy a desire to pass the business on to their offspring.

When valuing family-owned entities, business appraisers objectively consider whether family members are qualified for their positions and whether their compensation is *reasonable*. In some cases, management of a hypothetical buyer might want to consolidate family members' positions and use fewer people to perform their duties. As a result, valuation professionals often make an upward adjustment to cash flow to reflect the excess expense of employing relatives.

But the reverse may also be true. Some family businesses overwork or underpay related parties. Consider, for example, business owners whose passion for their work and desire to succeed lead them to work exceptionally long hours.

When evaluating a related party's compensation, experts look beyond the family member's base pay. For example, they must also adjust for payroll taxes, benefits and extraneous perks. Perks may include such things as allowances for luxury vehicles, country club memberships or loans at below-market interest rates.

## 2. Are there other related-party transactions?

Family-owned businesses may engage in other transactions with family members, such



as rental contracts, supply agreements and related-party loans. Experienced valuation experts know to inquire whether these transactions exist and are at arm's length.

In many instances, related-party transactions are sweetheart deals that require adjustments to the company's income stream. For example, suppose a boutique purchases the clothing line of a famous relative at a discount from what she charges unrelated retailers. If the boutique needed to be valued for, say, the owner's divorce, the expert would consider reducing its cash flow to the extent that the related supplier's prices are below market rates.

## 3. Is the management style casual or formal?

Family business owners tend to have a more personal management style that favors gut instinct and trust over formal written policies. Many family business owners also favor conservative business strategies and nonfinancial goals, which often lead to slower growth and lower profits.

Particularly when valuing controlling interests, experts consider how much a family-owned business would be worth in the hands of an unrelated hypothetical buyer.

In addition, the lax management style that characterizes many family businesses can lead to weak internal control systems — and even fraud. Valuation professionals take this additional risk factor into account and watch for the warning signs of fraud.

*Particularly when valuing controlling interests, experts consider how much a family-owned business would be worth in the hands of an unrelated hypothetical buyer.*

#### **4. Is a key person discount warranted?**

Although family businesses often rely heavily on one individual, key person discounts aren't appropriate for every family-owned entity. These discounts are relatively rare and reserved only for those businesses that would suffer a significant monetary loss if the key person left the company.

The typical approach to quantifying a key person discount involves estimating the company's monetary loss if the key person were to depart. Another approach is to estimate a percentage discount after considering several factors, such as the key person's skills, the company's financial position, employee turnover and management structure.

Owners can take preventive measures to safeguard their companies, such as requiring key managers to sign employment contracts. Family business owners may also consider implementing a viable succession plan or taking out a life insurance policy on the key person's life that lists the company as beneficiary. Such risk minimization techniques generally offset any key person discount.

#### **It's all relative**

Some of the world's largest and most successful companies are run by families. But these businesses also can be somewhat quirky. Experienced valuation professionals recognize common issues that family-owned entities encounter and, when necessary, adjust their methodology to estimate how much these businesses would be worth to third-party buyers and sellers in arm's length transactions. ■

*Parker v. Parker*

## **Trial court uses DLOM to achieve “fairness and equity”**

In this appraisal rights case, a New Jersey trial court applied a 25% discount for lack of marketability (DLOM) to punish a selling shareholder for his oppressive behavior toward the purchasing shareholder. Some valuation professionals worry that this decision could set an undesirable precedent in New Jersey and other jurisdictions that follow similar rules.

#### **Remedying decades of oppression**

In *Richard Parker v. Steven Parker*, two brothers were equal shareholders in three related businesses:

1. A company that installed plants and flower displays in commercial settings. (The plaintiff managed this business.)

2. A wholesale plant business and garden center. (The defendant managed this business and announced plans to close it on the first day of trial.)
3. A holding company that owned real property used by the operating businesses.

Each brother claimed he was an oppressed shareholder. After a lengthy review of the parties' grievances, the court granted the plaintiff's application to purchase the defendant's shares under New Jersey's Business Corporation Act. This law authorizes the court to compel any shareholder who's a party to litigation to sell his or her shares either to the corporation or to any other shareholder party for "fair value" in lieu of dissolution.



### Valuing the business interest

When the lawsuit and subsequent countersuit were filed, the brothers hired experts to value the defendant's interest in the commercial installation business. (The wholesale and garden center business closed a year after the trial began.)

Both experts used the discounted cash flow method. After adjusting his original cash flow assumptions at trial, the defendant's expert issued a modified report that valued the business at \$1,789,000. (His original

report concluded that the business was worth \$4,887,000.)

Using slightly different assumptions, the plaintiff's expert concluded that it was worth \$1,356,000. Then he applied a 15% discount for lack of control and a 25% DLOM. He also adjusted his appraisal for \$167,000 in shareholder distributions.

The court didn't allow any adjustments for lack of control or shareholder distributions. But, it accepted the plaintiff's expert's preliminary business value (\$1,356,000) and his 25% DLOM.

### Applying a DLOM

When estimating *fair market value*, private business interests may warrant a DLOM because there's no readily available market for transferring ownership and/or shareholder agreements may limit stock transfers. When estimating *fair value* in an appraisal action, the New Jersey Supreme Court has held that marketability discounts generally shouldn't be applied. But the law also gives trial courts substantial discretion in determining whether to apply a DLOM to achieve a "fair and equitable" result.

In *Parker*, the court concluded that the defendant's actions caused the lawsuit. Accordingly, "fairness dictates" that the defendant "cannot be rewarded" by refraining from applying a DLOM.

Some valuation experts believe this case sets a worrisome precedent. They argue that a DLOM should be explicitly tied to the facts of the subject company — such as the size of the block, restrictive shareholder provisions, dividend-paying capacity and historical dividend payments — rather than the oppressive conduct of the parties.

### Learning lessons from other business owners

Even if you don't do business in New Jersey, it's important to be aware of case law across state lines. Appraisal rights laws vary from state to state. But courts sometimes look to other jurisdictions for guidance when there's limited precedent in a state, especially if the state has enacted similar rules. ■

# Buy-sell agreements: How to cover all the (valuation) bases

Every business with more than one owner needs a buy-sell agreement to handle voluntary and involuntary ownership transfers. Additionally, it's important to update the agreement regularly to ensure it's still valid and addresses all of the business valuation issues that may arise.

## Which structure is right for the business?

Cross-purchase agreements give the company's *remaining owners* the right to buy a departing owner's interest either in one lump sum or in installments, depending on how the agreement is written. The purchase may be funded by insurance, if triggered by an owner's death or disability.

Alternatively, redemption agreements allow the *company* to purchase the departing owner's interest. The value is effectively transferred to the remaining owners by reducing the number of outstanding shares. Redemption agreements also may be funded by insurance policies (in which the company is named as the beneficiary).

## What valuation issues need to be covered?

Emotions tend to run high when owners face a "triggering event," such as the death of an owner, a divorce of married shareholders or a shareholder dispute. The departing owner (or his or her estate) suddenly is in the position of a seller who wants to maximize buyout proceeds. The buyer's role is played by either the other owners or the business itself — and it's in the buyer's financial interest to pay as little as possible. A comprehensive buy-sell agreement takes away the guesswork and helps ensure that all parties are treated equitably.

Some owners decide to have the business valued annually to minimize surprises when



a buyout occurs. This is often preferable to using a static valuation formula in the buy-sell agreement, because the value of the interest is likely to change as the business grows and market conditions evolve.

At a minimum, the buy-sell agreement needs to prescribe valuation protocol to follow when the agreement is triggered, including:

- How "value" will be defined,
- Who will value the business,
- Whether valuation discounts will apply,
- Who will pay appraisal fees, and
- What the timeline will be for the valuation process.

It's also important to discuss the appropriate "as of" date for valuing the business interest. The loss of a key person could affect the value of a business interest, so timing may be critical.

## Act now

Business owners tend to put planning issues on the back burner, especially when they're young and healthy and shareholder relations are strong. But the more details that are put in place today, the easier it will be for owners to resolve issues when it's time for a buyout. And, once the buy-sell agreement is in place, it's important to periodically review the agreement, as business values tend to change over time. ■



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**John M. Leask II (Mac), CPA/ABV, CVA**, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuers.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuers' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

More information about the firm's valuation services (including case studies) may be found at [www.LeaskBV.com](http://www.LeaskBV.com).

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at 203 - 255 - 3805. The fax is 203 - 380 - 1289, and e-mail is [Mac@LeaskBV.Com](mailto:Mac@LeaskBV.Com).

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If you have a business valuation problem, Mac is always available to discuss your options — at no charge.