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Business Divorce, Valuation and the Importance of a Buy-Sell Agreement

by Gerald A. Shanker

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Buy-sell agreements are among the most important agreements entered into by business owners. Notwithstanding the importance, many businesses do not have buy-sell agreements in place, and for many that do, the agreements are ambiguous and outdated. An effective buy-sell agreement will eliminate or reduce the disputes arising from the death or retirement of a shareholder, and the absence of an effective agreement may result in a protracted and costly dispute. This article will review the items frequently overlooked in drafting or updating buy-sell agreements.

To determine if an existing buy-sell agreement still works for a business, the value of the business should be calculated pursuant to the agreement as if a triggering event had occurred. If there are no disputes over interpretation of the agreement, all parties believe the value result is fair and the funding mechanism is in place to make the required payments, then the agreement is still acceptable. Many companies that perform this exercise find the existing agreement to be unsatisfactory and in need of change. It is much better to perform this exercise and identify problems with the agreement prior to occurrence of a triggering event. In evaluation of the results of this exercise, the parties usually will be open minded and fair, because they do not know if they will be a buyer or seller when the actual triggering event occurs.

Types of Buy-Sell Agreements

Buy-sell agreements fall into three basic categories: fixed-price agreements, formula agreements, and agreements requiring the performance of a valuation.

In fixed-price agreements, the price is specified in the agreement and is generally tied in to and funded by an insurance policy, which was most likely purchased at the time the agreement was executed. These agreements usually contain a provision requiring the fixed price to be periodically updated, but this provision is frequently disregarded. Problems can arise when a triggering event occurs and the fixed-price value has not been updated because the actual value may have changed since the last time the value was determined pursuant to the agreement. A fixed-price agreement will be respected even if the price bears no relationship to actual value. In the case of *Estate of Claudia Cohen v. Booth Computers and James S. Cohen*, the Appellate Division held a family partnership agreement that provides for a buyout based on net book value may be enforced even where the disparity between book value and market value is significant.[1]

In a formula agreement, the business value is generally determined by a relatively simple formula such as a multiple or percentage of net or gross income. The problem with formula agreements is that although the formula undoubtedly made perfect sense when the agreement was drafted, it may no longer be relevant or yield a result that bears any relationship to current value. Furthermore, if net income is a component of the formula, each expense paid by the business can become the subject of a dispute. The author recently served as a valuation expert in a case involving the interpretation of the formula provisions of a shareholder agreement. In that case, the plaintiff challenged the deduction of almost every expense paid by the corporation, resulting in a protracted dispute that was ultimately resolved by court decision.

Agreements that require the performance of a valuation by a qualified expert are most likely to yield a fair result and less likely to be the subject of dispute, as opposed to fixed-price or formula agreements. The performance of the valuation will require payment of professional fees, but these fees will be far less than those that would be paid in the event of a dispute. Agreements often require each party to engage an expert to perform a valuation, and if the results are not within a specified range of each other, a third appraiser is engage to perform a final, binding valuation. In these situations, the initial appraisers become advocates for their clients, resulting in widely disparate value results and the necessity of engaging a third appraiser. Significant time and money would be saved if the agreement required the engagement of the neutral appraiser, because the parties would pay for only one valuation report.

Standard of Value

Standard of value is an important element of a buy-sell agreement. In New Jersey, the most frequently used standards of value are fair market value and fair value. An agreement that uses the generic term "value" and does not state the standard of value to be used will be the subject of dispute.

Fair market value is the price at which a property would change hands between a willing buyer and a willing seller, both having knowledge of all the relevant facts and neither being under a compulsion to buy or sell. In New Jersey, fair value is generally fair market value without discounts for lack of marketability or lack of control. Because the discounts for lack of control and lack of marketability can be significant, the difference in the value result between fair market value and fair value also will be significant.

Triggering Events

Common triggering events in a buy-sell agreement include shareholder death, disability and retirement. Other triggering events that should be considered are divorce, loss of professional license or one's continued failure to perform duties.

The agreement should distinguish between normal retirement, that is retirement at or within a range of ages stated by the agreement, and early retirement, where the shareholder retires prior to this age or range. Early retirement may be problematic for several reasons, including loss of a key employee, potential competition, and timing the early retirement to create a financial advantage for the retiree.

If the subject business has experienced several highly profitable years or is anticipating an economic downturn, a shareholder may strategically time his or her retirement to maximize the value of his or her ownership interest and retirement payment. Such unexpected retirement may be detrimental to the business because of the unexpected loss of a key employee and the obligation to make payments to purchase the retiree's ownership interest. This can be prevented by establishing a minimum retirement age and requiring substantial notice of early retirement, for example, one full year. Although an agreement cannot prevent early retirement, it can penalize the early retiree by reducing the amount paid for the ownership interest. The agreement may also include a provision permitting the remaining shareholders to waive the minimum retirement age and notice requirement.

For retirement resulting from disability, the agreement should define disability and the circumstances that trigger the purchase, for example, the inability to perform duties for a specified period of time. Many disability provisions require the opinion of a licensed medical professional.

In many situations, the business interest is the most valuable asset owned by the shareholder. In the event of a divorce, it is subject to equitable distribution and its value will most likely be disputed by the non-titled spouse. If the marital estate does not have sufficient other assets to satisfy equitable distribution, the non-titled spouse may be awarded an ownership interest in the business. To prevent this occurrence, consideration should be given to requiring the divorcing shareholder to sell his or her shares to the other shareholders.

In a divorce situation, there may be a conflict between standards of value. The standard of value for New Jersey divorce is fair value, which results in a higher value than fair market value because fair value does not include discounts for lack of control and lack of marketability. If the buy-sell agreement standard of value is fair market value, there will be a difference between the amount paid by the business to purchase the shares and their fair value for equitable distribution purposes. Presumably, an argument could be made that the purchase price of the shares pursuant to a mandatory divorce sale provision is the value for equitable distribution purposes.

Valuation Date

Upon the occurrence of a triggering event, the valuation date is the effective date of the valuation. In performing a valuation, the valuation analyst can only use information that was known or knowable as of the valuation date. This is important because an event occurring subsequent to the valuation date cannot be considered in the valuation. For example, the loss of a key customer, supplier, or employee, or the introduction of a competitive product or new competitor, or even a decline in the economy after the valuation date may reduce the value of the company and the subject interest, but not as of the valuation date.

For practical purposes, buy-sell agreements often establish the valuation date as the most recently completed year, quarter, or month end preceding the triggering event. As many closely held businesses do not perform full monthly or quarterly closings, and business valuations often use three or five years' historical financial data, setting a valuation date when there is no normal closing will require additional work and higher costs.

Discounts and Premiums

Discounts for lack of control and lack of marketability frequently give rise to disagreement between business valuation practitioners, as well as between practitioners and the Internal Revenue Service. When faced with the testimony of opposing experts, New Jersey courts more often than not 'split the baby' by choosing discounts that are the midpoint between the experts.

To avoid controversy over application and amount of discounts, consideration may be given to specifying a range or maximum discount in the buy-sell agreement. The author's firm was recently involved in a case in which the shareholder agreement limited the combined discount to 30 percent. Although this maximum discount may have been slightly low, it eliminated a major point of conflict.

Tax Effecting

Most closely held businesses operate as S corporations, partnerships, or limited liability companies taxed as partnerships. With limited exception, none of these entities pay federal or New Jersey income taxes. They are commonly referred to as pass-through entities, because the business income or loss passes through to the owners for inclusion and taxation on their individual income tax returns.

Because pass-through entities do not pay income taxes, controversy exists whether income tax expense should be recognized in valuation of these entities. If income tax expense is not recognized, the business value will generally be greater than if income tax expense is recognized.

The arguments and logic are fairly complicated, but the Internal Revenue Service and valuation practitioners who do not deduct income taxes in valuing pass-through entities simply argue that the pass-through entity does not pay any taxes and therefore, none should be considered in the valuation. Practitioners who favor tax effecting argue that taxes are paid on the income, but they are paid by the shareholder, and a purchaser of an ownership interest in the business would consider the tax obligation in determining the amount he or she is willing to pay for the interest. Another argument that favors tax effecting is that the published rate of return data used in valuing businesses is calculated on an after-tax basis, so consistency and comparability require tax effecting of the subject company to make the data comparable.

If tax effecting is included in a valuation, the analyst calculates hypothetical income tax expense using a tax rate based on his or her professional judgment. Often, this rate is based on the personal income tax rates paid by the business owners who are paying tax on the income.

In drafting a buy-sell agreement, consideration should be given to expressly addressing tax effecting in the agreement. Making a decision on tax effecting and including it in the agreement will help eliminate a point of potential controversy upon the occurrence of a triggering event.

Funding

Many buy-sell agreements rely partially or fully on life insurance to pay for the business interest, which is fine if the triggering event is the death of the business owner. However, the purchase of an ownership interest triggered by disability, divorce, early retirement, or the loss of a professional license also require payment for the business interest, and life insurance proceeds will not be available for such payment.

Many buy-sell agreements provide for a down payment following by periodic installment payments, with interest. In an installment payment situation, the shares are generally held in escrow until full payment for the shares is received. This can be risky for the seller because if the business cash flow declines the business may not be able to make the required installment payments. Consideration should be given in the agreement to the consequences of nonpayment of the installment obligation. Many agreements provide that upon an event of default in the payment of the installments, the selling shareholder can take back his or her stock, but this remedy may not be satisfactory if the business has experienced a decline. In any case, the installment payment amount must not be so large that it negatively affects business operations, because no one wins if it does.

Continuing Benefits

The agreement should address continuing benefits, that is, the treatment of the retiring shareholder or his or her estate between the occurrence of the triggering event and the actual purchase of the business interest. For example, pass-through entities often make distributions to their owners to reimburse the owners for taxes paid on pass-through income when the income is not distributed to the owners. After a triggering event, an owner of an interest in a pass-through entity or his or her estate continues to be liable for taxes on pass-through income. The agreement should address whether the retiring owner will continue to receive reimbursement for taxes in the same manner as was done prior to the triggering event. Other continuing benefit issues to consider include continuing payment by the business of compensation; health, life and disability insurance; qualified plan contributions; automobile expenses; and other perquisites previously paid by the business. The buy-sell agreement should address these issues in as much detail as possible, identifying each item and the circumstances under which payments will or will not continue.

Professional Practices

Professional practices such as law and accounting firms, and other businesses in which revenue is dependent on the relationships and services of the owners present special problems. If efforts are not made by the retiring owner to transition his or her relationships to the remaining owners, some of the clients may not remain with the firm, reducing firm revenue and value. To prevent this situation, the buy-sell agreement should require the retiring owner to cooperate in the transition and be available for reasonable consultations. Consideration should be given to a reduction of the purchase price of the interest if there is a substantial loss of clients and the retiring owner did not assist in the transition as required by the agreement. This will give the retiring owner financial incentive to insure a smooth transition of his or her relationships. However, the retiring owner should not be penalized if the loss of business is due to factors outside of his or her control.

Due to the uncertainty related to the outcome of their cases, plaintiff and other contingent fee law firms are particularly difficult to value. Although the value of contingent fee cases can be estimated, the estimate could be incorrect and the outcome may be unfair to the firm or the retiring partner.

In a real-life example, the author's firm counseled a personal injury law firm in which a partner retired because of the onset of a sudden, fatal illness. As of the partner's retirement date, the firm had many large cases, some of which were near resolution and others in various stages of completion. All parties desired a fair result for the retiring partner, but did not want to obligate the law firm to make payments that it could not afford. To protect the firm and the retiring partner, a plan was designed under which the retiring partner received a percentage of fees on resolved cases, based on the resolution date. During the first 12 months after retirement, he received a full share of the fee income. After the first 12 months, the percentage declined each month, ending after 60 months. This payment plan only applied to cases that were open as of the retirement date. The rationale for the declining payment percentage was that a case resolved close to the retirement date was substantially complete as of that date, but cases resolved long after retirement most likely required substantial additional effort after retirement, to which the retiring partner made reduced or no contribution.

Selection of a Valuation Professional

If the buy-sell agreement requires performance of a current valuation, a valuation professional must be selected. Selection of the professional after the triggering event may be difficult. Consideration should be given to identification of the firm or individual who will perform the valuation, along with alternates who can be engaged if the primary firm or individual is unable to accept the engagement for any reason.

Conclusion

Although it is impossible to anticipate every contingency and the source of every possible disagreement, an effective buy-sell agreement that is understood by all parties will go a long way in reducing disputes. A business partnership is like a marriage, everyone is in love in the beginning, but the love may not last forever. An effective buy-sell agreement protects all the parties if and when the love ends.

As previously discussed, business circumstances change, and the buy-sell agreement may require periodic updating to reflect such changing circumstances. It may be uncomfortable for the parties to discuss sensitive buy-sell issues, but it is far worse to ignore them. Issues

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not addressed do not go away; they become bigger and more often than not must be decided by a judge. Review of client buy-sell agreements presents an opportunity for legal counsel to be proactive in providing a valuable client service.

Gerald A. Shanker CPA is a member of Kreinces Rollins & Shanker, LLC in Rochelle Park. He is accredited in business valuation by the American Institute of Certified Public Accountants. The concepts discussed in this article come from his experiences assisting in the resolution of shareholder disputes and from the book Buy-Sell Agreements for Closely Held and Family Business Owners by Z. Christopher Mercer.

Endnote

1. 421 N.J. Super. 134, 22 A.3d 991 (App. Div. 2011).

Call for Articles

We are seeking articles for the winter 2013 issue of the Business Law Section Newsletter on topics of interest to business lawyers in New Jersey and written by New Jersey State Bar Association members.

The deadline for submitting articles for the winter 2013 edition is **Nov. 1, 2013**.

Interested in submitting? Contact any of the editors:

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We look forward to hearing from you.