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Harvey v. Harvey
Buy-sell provision applies to divorce valuation

Delaware Chancery Court weighs in on fair value in statutory buyouts

Know the company's value before meeting with lenders

IRS hot button: Deductible management fees vs. disguised distributions

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Harvey v. Harvey

Buy-sell provision applies to divorce valuation

The Fifth District Court of Appeals of California recently addressed the valuation of a closely held business in connection with a divorce. Notably, the court valued the wife's 50% interest pursuant to the valuation provisions of a buy-sell agreement rather than the state's family code.

Background

The couple in this case jointly owned nearly 70% of the stock of a chemical manufacturing company that was founded by the husband. They also signed a buy-sell agreement that included a provision that specifically addressed the issue of a sale related to the marital dissolution or separation of a shareholder.

Under that provision, the husband was deemed to be the owner of the stock. It also outlined several ways in which the disposition of the stock could be handled in a divorce decree, separation maintenance agreement or property settlement. The method that the trial court ultimately followed gave the wife's interest in the company to the husband as a part of the division of community property.

The buy-sell agreement also included a valuation provision. It set the stock price at its fair market value (FMV) as agreed to by the parties. In the event that the parties couldn't agree, the provision required each party to appoint an appraiser to value the business. If the valuations were too far apart, the appraisers would appoint a third appraiser as the "final arbitrator of value."

Trial court decision

In an earlier proceeding, the wife requested that her interest be appraised in accordance with the state's family code, rather than under the valuation provision of the buy-sell agreement. The trial court denied this request, finding that, for purposes of a shareholder's divorce or separation, FMV was set by the agreement's valuation provision.

At trial, the husband's valuation expert valued the wife's interest at approximately $21.3 million, applying two valuation discounts for 1) a $2.5 million deferred tax liability and 2) a 22.72% discount for lack of marketability (DLOM).

The wife's expert valued her interest at approximately $40 million. He didn't adjust his conclusion for the deferred tax liability because it wasn't "immediate and specific." And he declined to apply a DLOM, finding that the buy-sell agreement "created a market for the shares" and that the company's stock was "highly marketable."

Given the disparity between the two appraisals, a third expert was brought in. He concluded that the valuation by the husband's expert "most closely approximated the actual value of the shares." The trial court accepted the $21.3 million valuation and ordered the husband to pay the wife that amount to "equalize" their marital assets.

On appeal

The appellate court agreed that, for divorce purposes, FMV was set by the agreement's valuation provision. The court also upheld the DLOM. It ruled that any criticism of the expert's methodology went to the weight of his testimony, which was strictly within the trial court's purview.

However, the appellate court rejected the adjustment for the deferred tax liability because it was attributable primarily to depreciation deductions that would later be reversed. The court noted that under California law, it's "improper to take into consideration the tax consequences of an order

dividing a community asset unless the tax liability is immediate and specific."

Draft buy-sells carefully

This case illustrates the importance of drafting buy-sell agreements carefully. Although the trial court allowed a DLOM in this case, it's conceivable that some courts would accept the argument that a buy-sell agreement creates a market for the stock, decreasing or even eliminating the discount. To avoid these issues, a business valuation professional can help the parties draft agreements that cover all the value-related bases. ■

Does your buy-sell cover all the valuation bases?

A comprehensive buy-sell addresses value-related matters to help ensure that all parties are treated equitably. You can hit a "home run" by addressing these four elements of value:

1. Definition of value. A valuation expert can provide definitions for a variety of relevant standards. Examples include the *book value* as listed on the company's balance sheet, *fair value* in accordance with the state's appraisal rights statute or *fair market value* as defined in Revenue Ruling 59-60. It's also critical to specify the valuation date in advance. For instance, that might be the date of the triggering event or the most recent fiscal year end.

2. Application of discounts. The parties should address if and when discounts for lack of control and marketability apply. Quantifying any applicable discounts in advance can also help facilitate the buyout process.

3. Valuation process. Some agreements base value on a fixed amount or a prescribed formula (such as a multiple of earnings or revenue). However, those methods are oversimplified and can become outdated. Instead, the parties could agree to hire one or more valuation professionals to determine value. The agreement should specify a process for selecting experts and a timeline for completing the valuation.

4. Payment of fees. Last, but not least, the agreement should specify who's required to pay the valuation fees (the buyer, the seller or the company).

Delaware Chancery Court weighs in on fair value in statutory buyouts

The Delaware Chancery Court recently found that reliable market indicators provide the best evidence of a corporation's fair value in statutory appraisal rights cases. Moreover, the court held that, in some situations, changes in value between the merger's signing and closing dates may be considered when buying out shareholders who dissent to a merger.

Why the market knows best

The court in *In Re Appraisal of Regal Entertainment Group* considered two market-based indicators — 1) the unaffected trading price of the corporation's stock, and 2) the deal price minus premiums paid for synergies — to be more reliable than a discounted cash flow (DCF) methodology. Although the DCF method is widely accepted, market-based methods

are generally preferred for deals involving public companies sold in an open market process.

Of the two market-based methods, the court decided that the deal price less synergies was the best measure of value in this case. Reliance on this measure was appropriate because there were several objective indicators that the sale process was sufficiently reliable, including:

- The acquiror was unaffiliated with and had no prior ownership of the company,
- Eight of the seller's nine directors had no conflicts of interest,
- There was robust public information about the company's value,
- The buyer conducted supplementary due diligence to uncover nonpublic information,
- The buyer and seller engaged in active negotiations over the price, and
- The parties entered into a merger agreement that permitted a post-signing market check that allowed other bidders to potentially emerge.

Regarding the unaffected trading price, certain factors rendered it less reliable. For example, a controlling shareholder had recently engaged in large block sales, and the corporation's stock price had recently fallen.

How to handle post-signing increase in value

In determining fair value, the court in *Regal* started with the deal price less synergies, then added an amount to reflect an increase in value between signing and closing. Why? After the deal was signed, but before it closed, Congress passed the Tax Cuts and Jobs Act of 2017 (TCJA). This law substantially reduced the corporate tax rate. So, the court increased fair value to reflect the company's anticipated tax savings under the TCJA. This decision was based on somewhat unusual circumstances: the enactment of major tax legislation that substantially reduced the company's tax burden.

> *Market-based methods are generally preferred for deals involving public companies sold in an open market process.*

However, in a more recent case — *BCIM Strategic Value Master Fund LP v. HFF, Inc.* — the Chancery Court expanded the availability of post-signing price adjustments to include situations in which value increases post-signing because of sustained outperformance. In this case, after the deal was signed but before closing, the company reported quarterly results that dramatically exceeded its internal projections and analyst expectations.

The court in *BCIM* found that the deal-price-less-synergies metric was the most reliable indicator of value. However, because fair value is measured at closing, the court held that an upward adjustment was appropriate to reflect the post-signing increase in value. The purchaser argued that short-term improvements didn't indicate a long-term trend that would justify an adjustment to the deal price. But the court concluded, based largely on management testimony, that the company's improved performance was "significant and durable."

To determine the amount of the adjustment, the court couldn't rely solely on the

increase in the company's stock price; some of the increase was likely in anticipation of the merger's closing. To determine the portion of the increase attributable to improved performance, the court relied on an expert who conducted a regression analysis of price changes in previous instances in which the company had outperformed earnings guidance.

Why valuation expertise is essential

As these two cases illustrate, value can fluctuate dramatically between the time a merger agreement is signed and the time it closes. A valuation expert can help you assess the impact of any fluctuations on the price of your deal. ■

Know the company's value before meeting with lenders

An understanding of a company's value is critical when applying for new loans to grow the business or renegotiating existing terms to be more favorable. Balance sheets give financial statement readers insight into a company's financial position — specifically its assets and liabilities — at a given point in time.

However, it can be dangerous to equate the book value of equity on the balance sheet with the company's fair market value. This is because current market values are based on *future* earnings and the prices paid for comparable companies. Thus, a balance sheet can present an incomplete picture of financial position.

Book value vs. fair market value

The balance sheet is a logical starting place for lenders when approving loans. And valuation professionals use it when applying the cost (or asset-based) approach to value a business. But it's important to recognize ways book value can differ from fair market value.

For example, intangible assets — brand names, patents, customer lists, goodwill and so on — are usually omitted from the balance sheet, unless acquired from a third party. Contingent liabilities also may be excluded.

Additionally, under U.S. Generally Accepted Accounting Principles, assets are reported at the lower of cost or market value. So, a building acquired 50 years ago might be worth far more than the balance sheet reflects.

Accelerated depreciation methods also tend to underestimate the value of property, plant and equipment. For instance, a fully depreciated tool, which has no value on the balance sheet, may continue to be used in daily operations.

Likewise, accounts receivable can include stale, uncollectible invoices, and some inventory items might be obsolete, missing or damaged. These anomalies are especially likely if the company's financial statements aren't audited.

It's noteworthy to compare net book value with the valuator's conclusion. Pinpointing the sources of discrepancies between these two values helps lenders understand what's driving value and what's missing on the financial statements.

Future earnings

Under the market and income approaches, a company's value is a function of its *future* earnings. Many factors inside and outside the business can alter future expectations.

Valuators evaluate a company's historical financial statements to determine trends. In addition to management's business plan and financial projections, industry research can help ascertain whether historical trends are likely to continue. For example, new technology or changing regulations can suddenly render a business obsolete.

Comparables

When valuation pros use the market approach to value a company, they rely on the sales of comparable businesses. Although details of private business deals aren't publicly reported, valuators have access to private transaction databases. This data reveals the selling prices and terms of deals in the company's industry.

Lenders often find comparable transactions particularly helpful when evaluating applications for loans to finance mergers and acquisitions. This portion of a valuator's analysis can also help lenders understand the industry in question and how the business measures up to competitors.

In addition, write-ups about company operations, industry analysis and financial trends can be informative during the underwriting process. A valuator's report also may disclose informal value indicators. The owners might, for instance, receive an offer to buy the business. Or they could need to estimate the company's value on a personal loan application or draft a buy-sell agreement.

The valuation equation

Balance sheet adjustments, future earnings, industry trends and comparable transactions are important parts of the valuation equation. Businesses that negotiate with lenders armed with this information can usually increase their odds of getting their applications approved quickly and burnish their reputations as trustworthy loan recipients. ■

IRS hot button: Deductible management fees vs. disguised distributions

The IRS may question the amount paid to shareholder-employees as tax-deductible salaries, bonuses and management fees. Excess amounts can be reclassified as distributions, which aren't deductible for federal tax purposes.

When assessing what's "reasonable," the U.S. Tax Court considers multiple factors together with the independent investor test. A recent Tax Court case — *Aspro, Inc. v. Commissioner* — demonstrates this approach.

9 factors

In *Aspro*, the Tax Court listed the following nine factors to consider when determining whether shareholder-employee compensation is reasonable:

1. The employee's qualification,
2. The nature, extent and scope of the employee's work,
3. The size and complexities of the business,

4. Comparisons of salaries paid with the company's gross and net income,
5. Prevailing general economic conditions,
6. A comparison of salaries with distributions to stockholders,
7. The prevailing compensation rates for comparable positions in comparable businesses,
8. The taxpayer's salary policy for employees, and
9. For small corporations with a limited number of officers, the amount of compensation paid to the employee in previous years.

No single factor is determinative. Instead, the court considers these factors on a case-by-case basis.

> ***The most significant factor was the prevailing rates of compensation for comparable positions.***

The most significant factor that worked against the plaintiff in *Aspro* was the prevailing compensation rates for comparable positions. Additional factors that supported the IRS position included the company's lack of historical dividend payments; payments to shareholders that roughly corresponded with ownership percentages; and payments made to corporate shareholders, not individuals. In addition, management fees were paid as year-end lump sums — such compensation is generally paid throughout the year as the services are performed.

Independent investor test

The Tax Court supplemented its multifactor approach with the independent investor test. This test asks: Does the company's shareholder-employee compensation level allow for adequate returns for hypothetical independent investors?

In *Aspro*, the taxpayer didn't present evidence or expert witness testimony on this issue. But analyses performed by the IRS's expert concluded that the taxpayer's operating income margins *after* paying management fees were significantly below those of its industry peers. Low profitability generally correlates with low investor returns.

The court agreed. It ruled that, after paying management fees to its three shareholder-employees, the business wouldn't have sufficient operating income left for hypothetical investors. Therefore, the management fees paid to the company's shareholder-employees over three years weren't deductible for federal income tax purposes; instead, they represented disguised dividends.

Beyond tax

Reasonable compensation can also be an issue outside of a federal income tax context. For example, it may play a role in shareholder disputes and divorce cases. An independent financial expert can provide objective evidence and detailed analyses to corroborate (or refute) the reasonableness of shareholder-employee compensation. ■

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