Jim Hitchner's Valuation Products and Services

VPS Q&A

A free Q & A periodical to promote education, build consensus and answer your questions in the financial valuation and litigation services industry.

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CONSIDERATION AND RELIANCE ON BUY-SELL AGREEMENTS

Question 1: When developing an estimate of fair market value for an interest in an operating entity, how do you consider (or do you consider at all) a buy-sell agreement clause that stipulates a buy-out formula not representative of fair market value? Does your answer differ if the interest is controlling, as opposed to minority? How does the venue or purpose (e.g. gift/estate tax reporting, marital dissolution, etc.) influence the answer(s)?

Answers breaking the questions down:

Question 1a: When developing an estimate of fair market value for an interest in an operating entity, how do you consider (or do you consider at all) a buy-sell agreement clause that stipulates a buy-out formula not representative of fair market value?

Answer 1a: It depends. If the standard of value for a valuation engagement is specified as fair market value, then a buy-sell agreement with a pricing provision other than fair market value would more than likely be considered irrelevant. However, things may not be so simple. In gift and estate tax matters, the pricing mechanism under a buy-sell agreement can be determinative of value if certain conditions exist. A good primer for understanding when a buy-sell pricing mechanism may be determinative of value lies in the Estate of Blount v. Commissioner. A review of Blount is beyond the scope of this response, but appraisers are advised to review this case and to refer this case to legal advisors, accountants, or executors who are involved in defining the value for such an appraisal. In summary, Blount mentions the following general conditions for translating a buy-sell pricing provision to a gift or estate tax valuation.

... (1) the offering price must be fixed and determinable under the agreement; (2) the agreement must be binding on the parties both during life and after death; and (3) the restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for a testamentary disposition.

Even if a buy-sell agreement is not deemed determinative of value for gift and estate tax purposes, then it does not mean that such an agreement should be disregarded for its potential impact on fair market value. In particular, a minority ownership interest can be subject to either enhanced or constrained marketability simply as a result of the existence of a buy-sell agreement, even if the subject interest is not directly a party to the agreement. Frequently, buy-sell agreements contain restrictions on transferability that limit the universe of likely investors and/or increase the risk profile of holding or acquiring an ownership interest. Accordingly, marketability discounts in such situations may be higher than would otherwise be the case. Thus, appraisers should carefully study the facts and circumstances of each valuation situation to determine if and how a buy-sell agreement may affect the magnitude of the marketability discount applied in the appraisal.

Question 1b: Does your answer differ if the interest is controlling, as opposed to minority?

Answer 1b: This question must be addressed in two parts (at least). As a matter of practicality (albeit with no absolutes), the fair market value of a controlling interest is not often constrained by the presence a buy-sell agreement. A hypothetical seller would not relinquish controlling ownership for consideration less than fair market value.

Alternatively, the subject interest in a buy-sell agreement may represent less than a controlling interest. However, the parties to the agreement may have agreed to transact on a controlling interest basis. In that case, it may be that a control value for the subject interest is appropriate.

Question 1c: How does the venue or purpose (e.g. gift/estate tax reporting, marital dissolution, etc.) influence the answer(s)?

Answer 1c: If the appraisal relates to a litigated dispute, other than taxes, then a buy-sell agreement may have little bearing on the valuation. In fact, the standard of fair market value is often not the standard of value for litigated matters such as shareholder rights and marital dissolution. In such matters, a buy-sell agreement containing pricing that unduly enriches or subjugates the interest of

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one party may be deliberately excluded from consideration by the Court. Alternatively, in defining the value for the engagement, the retaining party (most often an attorney) may provide specific instruction as to the consideration to be granted a buy-sell agreement. Of course, an appraiser should likely qualify any limitations of scope in his/her value determination.

Ultimately, appraisers rendering opinions in the litigation arena may be well-advised to seek instruction as to the consideration a buy-sell agreement should receive if such an agreement calls for a pricing mechanism that appears inconsistent with the definition of value required in the case venue. Specific facts and circumstances differ from state to state and according to the nature of the case (shareholder disputes and dissenting rights, divorce, etc.) Alternatively, the nature, intent, terms, and other aspects of a buy-sell agreement can influence how value may be assessed by an opposing party and the trier-of-fact. Every case and every venue is unique. Accordingly, a buy-sell agreement must be assessed through the appropriate lens regarding applicability and impact upon value determination.

Answer by: Timothy R. Lee, ASA, Senior Vice President, Mercer Capital Management, Inc. (Memphis) leet@mercercapital.com.

TIME HORIZON FOR LOST PROFITS CALCULATIONS

Question 2: **Have you ever seen or do you have an opinion on whether a lost profits calculation can go into perpetuity? In general, what is often the time period that lost profits can be projected out?**

Answer 2: Typically, lost profits are not calculated into perpetuity. Unlike a business valuation for which the "going concern" premise may suggest a calculation into perpetuity, a lost profits calculation for purposes of the resolution of a lawsuit must be calculated to a "reasonable degree of certainty." As the future projection period becomes longer, the expert's certainty that the projection will be achieved diminishes, and at some point the level of certainty is no longer reasonable. Lost profits should be measured only for that period for which there is a reasonable expectation that the impairment will continue.

Among the factors that an expert may want to consider in establishing the discount period are the economy, the industry, the market for the products, as well as changing competition and product life cycles. Other considerations are the quality and continuity of the company's management and the company's financial viability. A very important factor is mitigation, as the reasonable mitigation efforts of the damaged party often serve to not only reduce the amount of damages, but also shorten the damage period. In addition, lost profits evolving out of an alleged breach of contract may be limited by the remaining contract period. Calculating lost profits beyond the end of the contract period may be construed as speculation or perhaps based upon assumptions that are unreasonable.

When might it be reasonable to calculate lost profits into perpetuity? Perpetuity may be reasonable if the expert is measuring an earnings stream that is substantially the whole business, or a well defined and substantial segment of the business that has a stable history and could reasonably be expected to continue indefinitely into the future. Again, in a situation for which valuation into perpetuity may be appropriate, the discount rate will typically resemble a rate for valuing the business as a whole, as the rate would appropriately recognize all of the risks involved in a “going concern.”

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APPLICATION OF RESTRICTED STOCK STUDIES FOR DLOMS

Question 3: **In applying the restricted stock studies (RSSs) for determining a discount for lack of marketability (DLOM), it seems most appraisers are automatically assuming at least a two-year holding period applies for the stock of a closely held company in order to apply the higher discounts afforded by the pre-1990 RSSs. If there are no contractual restrictions affecting the sale of the closely held stock, isn't it likely that it could be sold in a period less than two years-- (maybe even less than one year)-- making the post-1990 RSSs more applicable? To me, this makes sense. But how often have you seen a report start with the post-1990 RSSs and qualitatively adjust up or down for other considerations (the same way you would if you started with the pre-1990 RSSs)? Your thoughts are always appreciated.**

Answer 3: The RSSs are used as a proxy for lack of marketability as we all know that there is usually little or no market for a minority interest in a private company without either a substantial discount of lots of bells and whistles, e.g., liquidity event. The two-year studies are only a starting point. Many appraisers believe that the discounts should be higher since most minority interests in private companies do not even have a two-year window for a liquidity event. While you theoretically can sell a minority interest, absent restrictions, at any time, there is little or no market. Who are you going to sell it to? One other thing-- the two-year restriction period is probably longer, and in some cases, much longer, because it is a two-year restriction and then, where applicable, the 144 dribble out rules kick in making the marketability period longer than two years, or longer than one year for that matter.

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