

VALUE ADDED™

DARRELL V. ARNE, CPA, ASA, CBI

5424 Arabian Drive, NW

Albuquerque, New Mexico 87120

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Telephone: (505) 898-2514 Telecopier: (505) 899-4476

The Top Ten Things Every Attorney Should Know About Business Valuation

It seems as if just about everything in American life is now condensed in a "top ten" list. Not to be left out of the trend, we have compiled our own "top ten" list – the "top ten things every attorney should know about business valuation." While a few of the items on the list might seem obvious, to many they are not. And, this list is by no means all-inclusive. We will add to it in the future but for now, let's begin with the "top ten."

- 1. Define the Project.** In order for the appraiser to schedule your work, set the fee and understand your client's specific needs, the attorney needs to provide some basic benchmark information, such as: describe the specific ownership interest to be appraised (number of shares, units, bonds); understand the "level of value" for the interest being appraised; specify the valuation date, which may just be current, or may be a specific historical date; describe the purpose of the appraisal (inform the appraiser why your client needs an appraisal and how the report will be used).
- 2. Understand the Standard of Value.** There are different standards of value for appraisals under certain circumstances and in different jurisdictions. Typical tax compliance appraisals are based on "fair market value," certain jurisdictions require "fair value" in dissenters' rights cases; and "liquidation value" may be appropriate in certain cases.
- 3. Involve the Appraiser Early On.** Even in straightforward buy-sell agreements, family limited partnerships, or corporate reorganizations, it is usually helpful to seek the advice of the appraiser *before* the deal is set, to see if there are key elements of the contract document that could be modified to provide a more meaningful appraisal to your client.
- 4. Distinguish Between a Business Appraisal and a Real Estate Appraisal.** Many of the corporate entities appraised either own or rent the real estate where the business is operated. For a successful operating business, the most meaningful valuation is typically based on some measure of capitalized earnings, rather than the

"Expect the Best"

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ESOP Appraisals and Non-ESOP Shareholders

The annual appraisal of the common stock of a closely held company for the purposes of its Employee Stock Ownership Plan ("ESOP" or "Plan") is a useful source of investment information for the company's management and shareholders. Nevertheless, the primary purposes of the appraisal are to establish a price per share for liquidating the accounts of departing Plan participants and to establish a *maximum* price for purchases of stock by the Plan from non-ESOP stockholders. Various factors peculiar to the ESOP's status as a qualified employee benefit plan, to the terms of the Plan document, and to the ESOP's relationship with the sponsoring company, however, prevent the appraised value from being definitive of fair market value for all shareholders in all circumstances.

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value of the underlying real estate. However, one should recognize that some businesses, due to the nature of their operations, are characterized more by their underlying assets, and less so by their earnings power. This is true for asset holding entities, and for some older family businesses with marginal earnings but with appreciated real estate on the books. Many business appraisers are not asset appraisers, but may need to consider a qualified real estate appraisal in the business valuation process.

5. **Establish a Reasonable Time Frame.** Your client's business appraisal is a custom piece of work and he may not have immediately available all the information requested at the outset of a valuation assignment. Typically, a valuation project takes between several weeks to complete once the authorization to proceed has been received. That can be accelerated to meet special needs, but it is usually a good idea to avoid rushing the production of a complex appraisal project.
6. **Insist on an Appraisal Firm with Experience and Credentials.** Each business appraisal is unique and experience counts. Most business valuation firms are generalists rather than industry specialists, but the experience gained in discussing operating results and industry constraints with a broad client base gives the appraisal firm lots of ammunition to understand your client's special situation. Credentials do not guarantee performance, but they do indicate a level of professionalism for having achieved and maintained them. Insist upon them.
7. **Know the Primary Business Valuation Methods.** Business valuation is an art as well as a science and appraisers will utilize and give different weights to vari-

ous valuation methods as they suit the particular needs of an assignment. Key methods typically utilized include: transactions method (focuses on actual transactions in the security being appraised); underlying net asset value method (considers estimates of fair market value of the entity's net assets, on a tax-adjusted basis); capitalization of earnings method (based on estimates of underlying earnings power times a derived capitalization rate); guideline company method (similar to the capitalized earnings method, but uses comparable, or guideline companies to derive the appropriate capitalization rate); discounted cash flow (derives the present value of future cash flows, based on a combination of projected future cash flow and a derived discount rate appropriate to the situation). Other valuation methods may be appropriate to certain companies in specific industries where specific comparable transaction data may be available.

8. **Consider the Appraisal as a First Line of Defense.** A well-reasoned and documented appraisal report serves as an indication of the seriousness and professionalism with which you address your client's needs. Having an independent appraisal in a transaction situation provides a level playing field for negotiations in good faith on both sides. For tax-compliance cases, the appraisal serves notice to the other side that they need to be equally prepared to support their opinion of value.
9. **Litigation Support Issues.** The business appraiser cannot serve as advocate for your client, but it is always helpful to have an experienced business appraiser available for expert opinion testimony. In addition to providing a well-reasoned and documented report, the appraiser must be able to articulate the reasonableness of valuation

and investment conclusions to the court and be able to deal with intensive cross examination.

10. **Expect the Best.** In most cases, the fee for appraisal services is nominal compared to the dollars at risk and the marginal cost of getting the best is negligible. You can help your appraiser do the best job possible by ensuring full disclosure and expecting an independent opinion of value. The best appraisers have the experience and credentials described above, but recognize the delicate balance between art and science that enables them to interpret the qualitative responses to due-diligence interviews and put them in a stylized format that quantifies the results.

Our firm has the experience and credentials to handle your client's appraisal assignment. For more information or to discuss a valuation issue in confidence, please feel free to call. ♦

ESOP Appraisals and Non-ESOP Shareholders

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A major feature of all ESOPs is the legally mandated put right granted to all Plan participants on company stock contributed to or acquired by the ESOP. Upon retiring or otherwise terminating employment with the sponsoring company, an ESOP participant generally has the right to have the shares in his or her account redeemed at the fair market value of the stock as determined by an annual independent appraisal. Many plans also allow departing participants to take direct ownership of their ESOP shares with the option of exercising the put right at a later date. In valuing healthy closely held businesses, most appraisers interpret the ESOP put right as substantially mitigating, if not eliminating, any *marketability discount* that would

otherwise apply. In cases where the ESOP is the majority owner of a business, appraisers often value the stock held by the Plan on a *controlling interest basis*, applying control level adjustments to earnings estimates and/or a *control premium* in developing an opinion of fair market value.

Some managements and non-ESOP shareholders presume that an ESOP stock appraisal is definitive of fair market value for every shareholder and every transaction occurring near the valuation date. In many circumstances such a presumption is incorrect. Examples of situations in which a non-ESOP shareholding should be appraised separately include:

- The ESOP holds a *controlling interest* and the subject interest is a *minority interest*.
- The ESOP holds a *minority interest* and the subject interest is a *controlling interest*.
- Both the ESOP's holdings and the subject interest are minority interests, but the illiquidity features of the non-publicly traded stock, namely lack of a ready market for the shares (and frequently, lack of significant or regular dividends), are substantially mitigated for Plan participants by the put rights attached to shares in the ESOP. This same put right does not benefit the non-ESOP shares.
- Both the ESOP's holdings and the subject interest are minority interests, but the non-ESOP block is subject to a restrictive shareholder agreement, such as a voting trust or a lock-up agreement.

Depending on the specific situation, use of the ESOP appraisal for non-ESOP purposes can lead to significant under- or over-valuation of the subject interest. The *premise of value* (controlling interest vs. minority interest) underlying the ESOP appraisal may be entirely inappropriate to the block of stock in question. Further, even when both blocks of stock are minority interests, ESOP shares are commonly assumed to be effectively freely trad-

able while a block of stock outside the ESOP remains nonmarketable and thus subject to a potentially large marketability discount in developing a corresponding opinion of fair market value.

Overpayment of gift and estate taxes is a common result of using ESOP appraisals for non-ESOP purposes. An estate holding or gift consisting of a nonmarketable minority interest may be grossly overvalued if the value the block is derived simply by multiplying the number of shares by a per share value taken from an ESOP appraisal in which the conclusion is premised

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upon a controlling interest or marketable minority interest level of value. Thus an estate holding or gift may be valued at a 20% to 40% premium or at only a 0% to 10% discount to the "as if freely tradable" minority interest value of the stock when in fact it should be valued at a 25% to 50% discount (or more).

Even in cases in which there is a history of frequent and substantial purchase transactions by or on behalf of the ESOP, there is usually no assurance that a non-ESOP stockholder will be able to sell his or her shares at the appraised value on a timely basis. A purchase of stock in a closely held company by a non-ESOP investor at the ESOP's appraised value per share can lead to disappointing returns if the investor has not secured an agreement from the company or other entity to guarantee a redemption at the ESOP value at some future date. Consider the following:

- The appraised value reflects the ceiling on what may be paid in consideration for non-ESOP shares. The ESOP trustee may decide to bargain for lower purchase prices in order to obtain higher returns for the Plan participants.
- Company management and the Plan trustee may elect to diversify the ESOP's holdings and/or build up liquid assets to fund redemptions of shares held on behalf of Plan participants thus reducing the volume of stock purchased from non-participants.
- Company management may elect to cut ESOP contributions in order to reduce compensation expense, cap the size of the ESOP's holdings, or fund other retirement benefits thus reducing the volume of stock purchased from non-participants.

The subject block of stock may exceed the likely number of shares to be purchased in ESOP transactions during any given year or during a multi-year period. The use of an ESOP valuation for non-ESOP purposes can result in significant problems to the seller/purchaser/holder of the stock in question. Determining the appropriate control and marketability assumptions attaching to the valuation of a block of stock in a closely held company requires the scrutiny of an experienced business appraiser. ♦

SPEAKERS' BUREAU

Members of this firm often participate in local and national speaking engagements, which include group seminars and speeches for attorneys, CPAs, CEOs, and other financial advisory professionals interested in topics relating to Business Valuation. Please call for further information or to discuss a specific speaking engagement.

Understanding Buy-Sell Agreements

Buy-sell agreements are designed to provide for the orderly transfer of ownership and control of businesses due to the planned retirement or untimely death or disability of a participating shareholder.

To be accepted by the IRS, a buy-sell agreement must meet the following criteria: create an obligation on the part of the estate of a deceased to sell the stock; set a fixed price, establish a formula or other means for calculation of fair market value of the stock; contain a right of first refusal; have a valid business purpose; not be for the purpose of transferring stock to family members at less than adequate consideration; contain terms similar to an arms' length transaction.

If the above criteria are not met, the tax liability on the sale of stock pursuant to a buy-sell agreement may be subject to taxation based on a higher value, while the still-enforceable agreement would result in the sale of stock at the contract price (theoretically, the

taxes owed on the sale of stock back to a company could be greater than proceeds received for the stock).

There are two basic types of buy-sell agreements: redemption agreements and cross-purchase agreements. A redemption agreement is an agreement between a business owner and a business. The agreement, which is usually funded with life insurance on the owner, requires the business entity to repurchase the business interest at a set price. A cross-purchase agreement is an agreement among shareholders or part-

ners of a business in which surviving owners are required to purchase the decedent's interest at a set price. Cross-purchase agreements are usually funded with life insurance policies, with each business owner holding a policy on the life of each of the other shareholder/partners. Other options include a required sale of a business interest to an ESOP or to an agreed-upon third party, such as a family member or key employee.

A buy-sell agreement must contain a pricing mechanism, of which there are three options: an agreed value; a for-

mula established in agreement; a third-party appraisal.

It would be generally unwise for any business to use an agreed value in its buy-sell agreement, because value will change over time. An agreed-upon formula for valuation of the business interests subject to a buy-sell agreement can be fair from the perspective of the business owners but using a for-

mula pricing methodology may cause the transaction to be challenged by the IRS. What was once a good method for valuing the company may not be appropriate

as the business changes over time.

The safest pricing mechanism for a buy-sell agreement is to have the interest appraised by an independent business appraiser. A solid, well-documented business appraisal is less likely to be challenged by the IRS. Once shareholders agree on the qualifications and independence of an appraisal firm, all know that valuation under the agreement will be objective and independent of any individual shareholder's interest and therefore fair to all shareholders. ♦

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ARNE FINANCIAL RESOURCES INC.
 BUSINESS VALUATIONS • BUSINESS SALES & ACQUISITIONS
 5424 Arabian Dr. NW Albuquerque, NM 87120-2247