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Valuations Plus

Buy/sell agreements: Don't be without one

A buy-sell agreement is one of the most important legal documents a closely held or family business can hold, along with the legally necessary documents such as articles of incorporation and partnership agreements.

Business owners involved in closely held corporations and noncorporate entities – such as proprietorships, partnerships or limited liability companies – should have a well-drafted buy-sell agreement in the event of death or disability of the owner or the owner's wish to sell or transfer interest in the company.

A buy-sell agreement addresses how and when owners can sell and must sell their shares. A well-drafted buy-sell agreement also formulates valuation criteria. Without a buy-sell agreement, most businesses face peril when the owners die, become incapacitated, divorce, retire, decide to sell or possibly file bankruptcy.

The consequences of not having a properly drafted buy-sell agreement in these situations can, and usually do, lead to expensive litigation and possible business failure.

The best time to make a buy-sell agreement for any business is before the first penny of income is generated. But a business can generate and agree to a buy-sell agreement once the business is in operation.

A buy-sell agreement provides for smooth transition of a business interest, according to the Center for Financial, Legal & Tax Planning Inc., by:

- Identifying triggering events
- Specifying to whom or to what the business interest must be sold
- Providing a mechanism to determine the purchase price
- Providing a funding source
- Establishing a valuation for estate tax purposes

The basic forms of buy-sell agreements are stock redemption agreements, cross-purchase agreements and the mixed agreement.

A stock redemption agreement, also known as stock restriction agreement, provides for the purchase of an interest by the entity itself, as differentiated from an agreement between business associates.

A partnership redemption plan, referred to as an entity plan, provides for the partnership to retire the exiting partner's interest under specific conditions. A corporate stock redemption plan, used in closely held corporations, provides for the corporation to redeem or retire the affected shares.

A stock redemption agreement requires corporate approval because the agreement involves the corporate entity repurchasing the affected stock. The stockholders approve and sign the agreement with the company. Usually the company has only one agreement approved by the company and signed by all stockholders.

The cross-purchase agreement takes the form of a contract among stockholders. The stockholders purchase an existing shareholder's share of the business interest on an individual basis.

A cross-purchase agreement among partners/shareholders provides that, if one of the partners exits, the remaining partners/shareholders will receive the exiting partner's interest in exchange for the price specified in the agreement.

Proprietors may make similar agreements with key employees, while partners or shareholders in closely held corporations may make such arrangements with other partners or shareholders or key employees. Each shareholder or partner usually signs a separate agreement with every other stockholder or partner. The agreements do not have to be the same. Each is unique to the

See **Buy/sell agreements** *inside*

Valuations and litigation support information from the office of:

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What improvements should you make before selling your business?

You've made the decision to sell. How can you get the most for your business?

It likely won't be by putting it on the market as is, unless you're one of the fortunate few who sell at the lifecycle peak. Too many owners wait until the business is in the decline phase and is losing value daily.

Wisdom from the real estate field works here. Maximize your curb appeal. Make quality upgrades that add value. Give your systems a tune-up. Clean up outstanding issues that might impede a sale.

Following this advice will cost money. But if invested wisely, the return will be much more than the dollars spent. The improvements could also make the difference between your business being sold or languishing on the market.

Choosing improvements with the buyer in mind is key. That's why certain home upgrades are recommended while others are considered a wash or a loss.

In preparing your business for sale, you must do the same things – cast a critical eye over your enterprise and understand how your potential buyers will evaluate its desirability.

Technology

Technology, including hardware, software and communications systems, is a vital part of operations in most industries. Sleek equipment, current software, and up-to-snuff security protocols give an impression of cutting-edge performance.

Conversely, outdated equipment and ancient versions of software give an immediate impression that your business is also functioning in the past – slow, out-of-date, behind the curve.

Not only will new owners be required to make upgrades, probably resulting in a lower sales price, but that unfortunate impression might extend to company performance as a whole.

Potential buyers may cast a jaundiced eye over the books and market prospects for the company. How can you be positioned as a leader when your technology is obsolete? In addition, the new owners will need to invest in transitioning systems to the new technology and training employees.

Before making any upgrades, determine current standards in your industry. Identify trends impacting the use of technology. For example, if your competition is using point-of-sale software and storing data in the cloud, perhaps you should also.

The next step is an assessment of what you currently own and use. Over time, many companies end up with a hodgepodge of computers and software.

Telephone systems and other office equipment should also be reviewed. Determine which upgrades are the most critical. Once they are purchased, you will need to be sure that employees are trained and that documentation regarding protocols and use are created or maintained.

On the positive side, you may find that new technology reduces operating costs. Certainly hardware costs have come down significantly, and the availability of cloud-based software means a monthly payment instead of a purchase. Increased productivity might create a positive impact on the bottom line, which in turn makes the business more valuable.

Interior, exterior and equipment

Other investments you should consider involve signage, your premises, business vehicles and equipment.

Signage is an often-overlooked asset that immediately conveys much more than the words displayed. A faded, broken, inadequate or outdated sign conveys a business on the decline. You're used to it and so are your customers, but a buyer will see it with fresh eyes. New signs aren't cheap, but they could make the difference between interest and an immediate turn-off.

Take a fresh look at the curb appeal of your premises. A good way to do this is to take photographs so you can view the building and grounds honestly, without bias.

Inside, how are the carpets and lighting? Faded and flickering won't cut it. Layout is key, as is minimizing clutter and getting rid of junk. Old paperwork and outdated items tend to accumulate, often becoming invisible to those who see them every day.

If you don't have time to purge and decorate, consider putting one of your more organized employees on the task or hire a professional.

Finally, check over your equipment and vehicles. If you can't afford to upgrade or replace old items, at least clean and repair them. It's the same philosophy behind detailing a used car. First impressions count. – *Elizabeth Penney, M.B.A.* ■

Buy/sell agreements *continued from front*

parties signing the agreement and is only between the parties signing that agreement.

Mixed agreements are the third type of buy/sell agreement. The entity is given the first option to purchase the shares of a stockholder. To the extent the shares are not purchased by the entity, they can then be purchased by other shareholders usually in direct proportion as the ownership. If the shareholders do not purchase all of the remaining shares, the entity may purchase the remaining stock.

Many agreements have a clause requiring either the entity or the remaining stockholders to purchase "all or nothing." Stockholders and companies are banned from purchasing just enough stock to give them controlling interest in the company, according to The Center for Financial, Legal & Tax Planning, Inc.

Good things happen when you plan to have a buyout agreement that spells out the owner's rights and obligations when an ownership transition occurs. – *Tracy A. Heider Winrow, Attorney/CPA* ■

Hidden liabilities that affect the value of a business

No business is perfect.

Some liabilities or poorly performing assets are obvious – debts and payables, uncollectable accounts receivable, obsolete equipment and warranty agreements.

How the sale is structured will determine the new owner's responsibilities regarding these issues.

Unfortunately, even if everything looks fine on the surface, hidden liabilities can appear to impact both the buyer and the seller. Many a lawsuit has been filed claiming negligence or even fraud on the part of the seller for failure to disclose contingencies with a material affect on the business.

To be fair, some of these issues blindside the seller, too. That's why a thorough assessment of potential liabilities should be conducted before the business goes on the market. Having a hidden liability come to light during the sales process could derail the process entirely and will certainly have an impact on the selling price.

Examples of hidden liabilities include:

Litigation – Lawsuits pending, in process or possible are definitely a liability. Part of the problem is the inability to know in advance the full impact on the business. Even if the lawsuit is settled in the business's favor, there are costs associated, both for attorneys and to the reputation of the company.

If a lawsuit is defined as probable – i.e., likely to occur – and an estimate of losses can be made, it must be disclosed on financial statements, according to generally accepted accounting principles (GAAP).

Unfortunately, even if everything looks fine on the surface, hidden liabilities can surface to impact both the buyer and the seller.

If the probability of loss is reasonably possible, then GAAP also requires disclosure. The gray area is when an event appears remote, yet something may already be in play that will result in a future suit.

During audits, legal opinions regarding probable outcomes and losses are sought. If your company has a history of lawsuits or your industry is subject to them, it would be wise to have a legal evaluation of your risk prepared.

This area is especially important during an asset sale when it is commonly believed that such liabilities do not follow the sale. Court rulings have tested this assumption to the detriment of the buyer.

The California Supreme Court ruled that the purchaser of a manufacturing business was not covered by the previous owner's insurance when it came to product liability claims, although the purchases were made during that coverage period. (*Henkel Corp. v. Hartford Acc. & Indem. Co.*, 62 P.3d 69, Cal. 2003).

In the case of *Ray v. Alad Corp.*, the court ruled that the purchasing company is liable for defects caused by the previous owner, creating the product line exception. (*Ray v. Alad Corp.*, 19 Cal.3d 22, 560 P.2d 3, 136 Cal. Rptr. 574, Cal. 1977).

It's vital that these potential situations be identified so the buyer, seller or both can purchase insurance to guard against possible lawsuits.

Environmental issues – A similar situation may arise with environmental issues. If the company at any time manufactured products, goods or buildings using injurious or defective materials, there is possible liability for buyer, seller or both.

The Michigan Supreme Court found the buyer liable despite an asset sale because the buyer presented the company as a continuation of the seller to the public. (*Turner v. Bituminous Casualty Co.*, 244 N.W.2d 873, Mich. 1976).

The court's ruling asserts that if the buyer uses the same name, premises, processes, designs and trademarks, then the company appears to be under continuous ownership and therefore is liable.

Environmental issues can also arise with regulations governing waste disposal and handling of materials. The problem can be mishandling of both, or it may be that new, stricter regulations will soon be imposed.

Although the buyer should be aware of industry requirements and perform due diligence on the site, it can only help the seller to assist with this process. Banks often require environmental site assessments before approving a mortgage, so discovery of contamination will sink a deal fast.

Tax liabilities – Depending on tax structure, type of business and location, tax liabilities can come in different packages.

The prompt and thorough payment of employment taxes is an area that should be cleaned up before a sale. The federal government frowns on late tax deposits and will levy huge fines and interest against an employer who fails to comply with the law.

If the company is a corporation and owes taxes at the entity level, this must be cleared up before the sale.

If your company collects sales taxes, a sales tax review will give the buyers assurance that there won't be any surprises after the sale because they will be liable. If you're current, why wait for the buyers to execute their own review?

Proactively cleaning up problems and preparing proof that your company is free of hidden liabilities will do a great deal to smooth out the selling process. – *Elizabeth Penney, M.B.A.* ■

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Tax Court criticized in estate's art collection case

The collection includes artwork by many famous artists, including Pablo Picasso, Paul Cezanne, Jackson Pollock and Henry Moore, to name a few.

The question was how much a partial interest in the art collection of Houston millionaire James A. Elkins was worth – and if a discount was due.

About one quarter of the collection had been gifted to Elkins' three children before his death. When Elkins died in 2006, the collection of 64 works of art was valued at nearly $35.2 million.

The estate claimed a 44.75 percent discount from that value for lack of control and lack of marketability.

The IRS, on the other hand, argued that no discount should be given in valuing fractional interests in art.

In the original case before the Tax Court in 2013, *Estate of Elkins v. Commissioner,* 140 T.C. No. 5 (March 11, 2013), the estate had three different experts: one in art valuation, one on partition proceeding costs and one on the valuation of fractional interests in property.

After hearing debate from both sides, the court ruled that a discount is available for partial ownership for estate tax purposes and that discount should be a 10-percent discount from fair market value.

The estate appealed, and the United States Court of Appeals, Fifth Circuit, on Sept. 15, 2014, agreed with the Tax Court that a discount was available for partial ownership in the artwork.

But the appeals court let the IRS know it was not happy with the IRS's argument that no discount should apply and called on the IRS to make good-faith estimates when challenging taxpayer experts.

The district court also criticized the Tax Court's routine handling of cases by acting as an appraiser who comes to a compromise between the positions of the IRS and the estate.

The appeals court decision said the 10-percent discount imposed by the Tax Court "leaves us with the definite and firm conviction that a mistake has been made."

The district court found the estate's original discounts as "not just the only ones proved in court; they are eminently correct."

By agreeing with the estate's discount, a refund of more than $14 million in overpaid taxes, plus interest, was ordered by the court.

The court said the burden of proof is initially on the estate to establish a good-faith evaluation. That burden of proof shifts to the IRS to show why the taxpayer's valuation is insufficient. ■

The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation.

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