

# Viewpoint on Value



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## Look for the silver lining

**A volatile market translates into higher marketability discounts**

Think outside the box in divorce

Creating a reliable buy-sell agreement

**A valuation provision must be at its heart**

# Look for the silver lining

A volatile market translates into higher marketability discounts

**M**arketability is the ability to quickly convert property to cash at minimal cost, according to the *International Glossary of Business Valuation Terms*. Also implied is a high degree of certainty that an expected selling price will be realized.

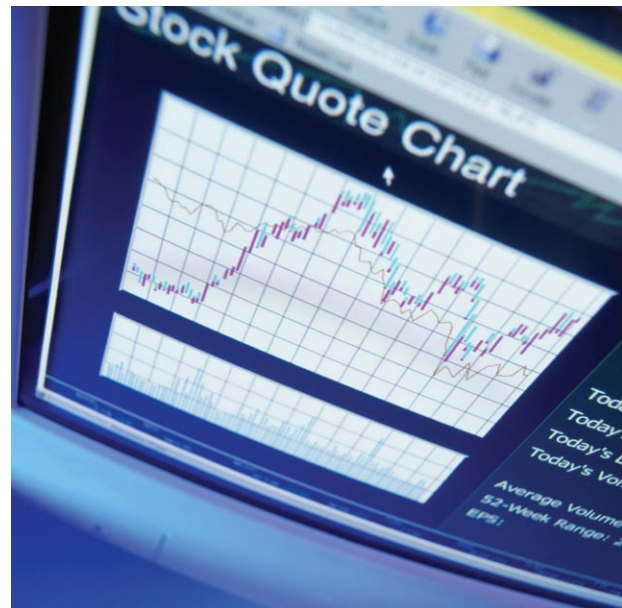
But if there's one thing the market has *not* been over the last couple of years, it's certain. Recent market volatility may well translate into higher marketability discounts, because investors pay less for illiquid, risky investments. So the silver lining to economic uncertainty is that it provides an opportunity for wealthy individuals to gift private business interests at significant discounts, potentially saving a substantial amount in taxes.

## Gauging investor sentiment

High volatility typically lowers marketability by making investments less attractive. But estimating private stock price volatility can be difficult because published stock prices for privately held shares don't exist — and private transactions are few and far between. Recently, valuers have turned to public volatility metrics to capture the specific effect volatility has on private marketability discounts.

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One popular gauge of market volatility is the Chicago Board Options Exchange Volatility Index® (VIX®). VIX measures the expected volatility of Standard & Poor's (S&P) 500 index options over the next 30 days. Also known as the "fear index," VIX tells whether investors expect sharp changes in market prices — either upward or downward.



In general, a VIX of 30 indicates relatively high volatility while a score of 20 or less suggests calmer market conditions. In October 2008, VIX approached 90, a record high since the index started in 1993.

In an annually published database, *The FMV Restricted Stock Study*™, FMV Opinions provides a comparison of restricted stock transactions in the first and second halves of 2008 showing a direct relationship between VIX and observed restricted stock discounts. This empirical evidence indicates that volatile market conditions warrant higher marketability discounts.

## Looking beyond volatility

The two most popular sources of empirical data valuers use to support marketability discounts are restricted stock and pre-initial public offering (IPO) studies, according to a September 2009 *BVWire*™ poll. These studies suggest that marketability discounts for minority interests in private companies range from 30% to 50%. But marketability discounts

can vary significantly depending on the specific characteristics of the subject business interest.

Volatility is just one factor that affects marketability. Other considerations include:

**Put rights.** The owner of a put option has the right, but not the obligation, to sell his or her interest at a prescribed price — usually for a limited time. Put rights are frequently granted to employee stock ownership plan (ESOP) participants. Put rights create a market for transferring ownership and, therefore, support a *lower* marketability discount.

**Pool of potential buyers.** The more potential investors that are available — often demonstrated by historic trading volume — the more marketable the

business interest is and the *lower* the marketability discount. The size of the investor pool also may be statutorily restricted. For instance, in some states, only licensed professionals can own an interest in a law firm or medical practice. Similarly, tax regulations limit S corporation ownership.

**Company size and financial performance.** Investors often perceive small companies, startups and underachievers as riskier ventures. Accordingly, these underdogs warrant *higher* marketability discounts.

**Size of the block.** Large blocks of stock take longer to sell and may flood the market with excess supply. Large blocks also have fewer potential buyers and are harder to finance. So, the size of the block and the marketability discount are positively correlated.

## A quick-and-dirty marketability checklist

A September 2009 *BVWire*<sup>™</sup> poll of valuation professionals found that 83% routinely refer to the case *Bernard Mandelbaum, et al. v. Commissioner* and consider the *Mandelbaum* factors when quantifying marketability discounts. These nine factors include:

1. Financial statement analysis,
2. The company's dividend policy,
3. The nature of the company, its history, its position in the industry and its economic outlook,
4. Company management,
5. The degree of control in transferred shares,
6. Restrictions on transferability,
7. The holding period,
8. The company redemption policy, and
9. The costs associated with making a public offering.



The poll suggests that the most relevant criterion is transfer restrictions, with 98.7% of participants considering whether buy-sell or other owner agreements restrict stock transfers. The factor with the lowest response rate (39.7%) was initial public offering (IPO) costs.

While they may not specifically cite the controversial *Mandelbaum* case in their valuation reports, most experienced valuers look beyond empirical study averages and make specific connections between transaction data and the business interest in question.

**Potential for sale or public offering.** An imminent private sale or public offering effectively creates a market for the company's stock. Although these prospective transactions could fall through, they tend to *lower* marketability discounts. Conversely, if the controlling owner has no intention to sell or go public, the interest warrants a *higher* marketability discount.

Without dividends, selling out is the only way for a shareholder to realize a return.

**Access to reliable financial information.** Investors want timely, accurate financial information. If management refuses to release financial reports or lacks the requisite accounting expertise, investors will pay less for the investment, warranting *higher* marketability discounts.

**Contractual agreements.** Buy-sell and shareholder agreements may, for example, restrict stock transfers or set a fixed price for buyouts. But it's important to

consider whether these provisions are legally enforceable before taking them at face value.

**Dividends.** Cash distributions provide an interim return to investors. Without dividends, selling out is the only way for a shareholder to realize a return. Empirical studies show that dividend payments increase the desirability of a given investment and, therefore, *reduce* marketability discounts.

Valuators consider these same factors in other parts of their analyses. For example, these considerations may come into play when quantifying the discount for lack of control, blockage discounts, or the cost of equity (under the income approach). To avoid undervaluing the subject business interest, however, appraisers are careful not to double-count risk factors.

### Defending the discount

All else being equal, the current uncertain market conditions may warrant unprecedented marketability discounts. But a blind application of discount studies is likely to attract unwanted IRS attention. A thorough analysis that compares transaction data with the specific characteristics of the ownership interest being valued will help tax returns withstand IRS scrutiny. ●

## Think outside the box in divorce

The rules governing equitable marital dissolutions vary from state to state. But it's not uncommon for divorce courts to consider cases in other jurisdictions — especially in the absence of relevant legal precedent in their own jurisdictions. To avoid stalemates and unexpected surprises, it's a good idea to hire a well-rounded valuator who can identify potential roadblocks and explain how they've been handled in other jurisdictions.

*Wechsler v. Wechsler*, one of the largest court-imposed settlements in New York state history, illustrates out-of-the-box thinking. In this case, the New York Appellate Division One Court accepted a deduction



for 100% of a company's built-in capital gains tax liability based on U.S. Tax Court precedent.

### Differing discounts

The Wechsler's largest asset was a private C corporation that held a \$71 million portfolio of marketable securities. Many of the holding company's assets had appreciated significantly from the time of purchase and would incur substantial capital gains tax at the corporate level if sold.

At trial, the husband's expert and a third "neutral" expert argued for a dollar-for-dollar reduction for built-in capital gains tax, based on an earlier case, *Estate of Dunn v. Commissioner*. The underlying logic for this reduction was that investors consider prospective taxes when buying an interest in a holding company. Rather than be encumbered by the holding company's low tax basis, investors could just as easily directly purchase a portfolio of the same or very similar marketable securities. The experts in *Wechsler* agreed to apply a 41.74% effective tax rate to estimate built-in capital gains tax obligations.

Conversely, the wife's expert calculated that the deduction for built-in capital gains tax should be 11%, based on the holding company's historical rate of annual taxes paid compared to its average annual gross revenues. The Manhattan Supreme Court accepted the discount quantified by the wife's expert, citing *Estate of Jelke v. Commissioner*. The husband appealed.

### The wife's expert couldn't cite an authoritative reference endorsing the methodology.

#### Second time's a charm

The husband argued that the 11% historic rate was a "meaningless percentage to apply to the capital gains," especially since a 2006 Tax Court ruling disallowed several historic expense deductions taken by Wechsler's holding company.

Neither the husband's expert nor the neutral expert had ever seen a historic tax rate based on annual revenues used to estimate built-in capital gains tax obligations. And the wife's expert couldn't cite an



authoritative reference endorsing the methodology. In addition, the appellate court noted that *Estate of Jelke*, which the trial court cited in its decision, had later been reversed by the U.S. Court of Appeals for the Fifth Circuit.

Consistent with *Estate of Dunn*, the appellate court decided that the trial court should have assumed a company sale on the valuation date (the date of divorce filing) and reduced the holding company's net asset value by 41.74% for built-in capital gains tax obligations.

### An open mind helps navigate complex issues

Family courts are increasingly familiar with business valuation matters, and judges often look for outside guidance on complex issues such as valuation discounts, comparable transactions and goodwill.

*Wechsler* is one of many examples that provide an excellent summary of built-in capital gains tax case law. It demonstrates the importance of considering Tax Court precedent if a marital estate includes a holding corporation with significant built-in capital gains tax obligations. ●

# Creating a reliable buy-sell agreement

A valuation provision must be at its heart

A buy-sell agreement can be an important tool in smoothing any business ownership transition — whether the aim is to maintain control, provide liquidity and a ready market for the stock, retain key employees or ensure an orderly ownership transfer in the case of death, disability or divorce. Of course, it's important to decide how to fund the agreement (for instance, via life insurance, disability insurance or a sinking fund). But at the heart of every successful buy-sell agreement is a well-reasoned, supportable value.

## The best approach

Several possible valuation approaches can help set the price in a buy-sell agreement. Many agreements use a formula or rule of thumb such as book value or some multiple of earnings or cash flows. Some base the price on the shareholders' judgment of value. But these methods can easily lead to under- or overvaluation, or to conflicts among the shareholders.

So the best approach is to provide for valuations by one or more independent appraisers, either periodically or at the time of a triggering event. A buy-sell agreement that requires an independent appraisal may call for a single appraiser or two or three appraisers. Some agreements, for example, provide for the buying and selling parties each to select an appraiser. If their valuations are within a specified percentage of each other, the average of the two sets the price. But if their valuations are too far apart, a third appraiser (often selected by the first two appraisers) chooses the “winning” valuation.

Alternatively, the third appraiser might perform a separate valuation, which then is averaged with the others. The possible arrangements are practically limitless. The important thing is to be sure that the agreement clearly spells them out.



## Timing is everything

Another significant consideration, especially if using a single appraiser, is when the appraiser will be selected. Many buy-sell agreements provide that the parties will select an appraiser after a triggering event occurs. But there are two significant drawbacks to this approach. First, it may be difficult for the parties — who now have conflicting interests — to agree on someone. Second, even if both parties are comfortable with the appraiser, the outcome will be uncertain.

A more effective strategy is to select an appraiser at the time the agreement is signed. Ideally, the appraiser will perform a valuation at that time to set the initial buyout price and then reevaluate the business annually (or every two or three years). This allows the parties to become comfortable with the appraiser's methods and conclusions and to get a handle on what the buyout price will be.

If a triggering event occurs, the buyout price is based on the most recent appraisal. But many agreements

## Discounts, premiums and a fair price

Even if a buy-sell agreement specifies a standard of value, the *level* of value — which can range from a controlling interest to a marketable minority interest to a nonmarketable minority interest — can have an enormous impact on the outcome.

Parties to buy-sell agreements often assume that value is based on their pro-rata share of the value of the business as a whole. But without further direction, an appraiser might adjust this value to reflect control premiums, minority interests or marketability discounts.

To avoid unintended consequences, the agreement should clearly specify which discounts or premiums, if any, apply. The parties might feel, for example, that a fair price is the fair market value of an owner's interest, without regard to discounts or premiums.

provide for a new appraisal if the most recent one is out-of-date (more than a year old, for example).

### Clarifying terms

One of the leading causes of disputes in buy-sell agreements is their failure to provide valuation guidelines and define key terms such as:

**Standard of value.** Too often, buy-sell agreements merely state that the buyout price is the value of an interest in the business. But “value” can mean different things in different contexts, so the agreement needs to spell out whether the price should be based on fair market value, fair value, investment value or some other standard.

**Valuation date.** All appraisals value a business or business interest as of a certain point in time, and the valuation date can have a big impact on the result. The agreement should specify whether the date used is the date of the triggering event, the last day of the company's most recent fiscal year or some other date. Using a specific date rather than the date of the triggering event discourages owners from timing their departures to maximize the buyout price.

### Other considerations

Federal estate taxes are another important consideration, especially when a family business is involved. Buy-sell valuation provisions are generally enforceable in the courts, but the IRS might not accept the buyout value for estate tax purposes unless the parties can show, among other things, that the valuation provision is comparable to one negotiated at arm's length by unrelated parties.

Other issues to consider include time limits for completing various valuation steps, appraiser qualifications and alternative dispute resolution (such as arbitration or mediation). The preferred method of resolving valuation problems inherent in buy-sell agreements is an agreement requiring shareholders to abide by independent findings if the agreement's terms trigger a valuation.

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### Seek professional help

Independent professional valuation services increasingly are favored in buy-sell agreements because shareholders must agree on a valuation firm's qualifications and independence. The resulting valuation under the agreement will be objective and independent of any individual shareholder's interests, and therefore fair to all shareholders.

In addition to maintaining corporate harmony, independent valuation can also help you and your partners avoid legal battles. Objectively derived company stock values stand up well under IRS and court examination. By planning for all possible contingencies and incorporating reasonable, clearly defined valuation guidelines, you can help ensure a smooth transition in a difficult time. ●