

Stock buy-back agreement in valuation

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Many closely held businesses will provide, by contract, that upon certain events an owner's interest in the business enterprise may be purchased by either the business organization or the other owners. Typically, these put/call options are set forth either in a buy-sell agreement in the case of a corporation or in the company operating agreement in the case of a limited liability company; however, absent such an agreement there is neither a right to force the corporation/LLC to buy an interest nor a right in the corporation/LLC or the other equity owners to acquire the interest. On the other hand, the Kentucky general partnership statute permits partners to withdraw from the venture and possibly receive compensation for their interests; this provision is subject to modification in the partnership agreement.

Two of the common problems that arise when applying buy/sell agreements relate to (a) the application of a contractual or statutory valuation methodology and (b) whether the contractual or statutory valuation formula should apply to third parties.

Assuming that an event triggering a put or call right has occurred, there will then arise the question of valuation. All too often the agreement will contain an indefinite standard such as "fair value" or "fair market value" that will require legal interpretation. See also Thomas E.

Rutledge and R. David Lester, *Fair Value – With or Without Discounts: Are the Rules Changing in Dissenter Rights Actions?*, 6 Kentucky CPA Journal 28 (2010). Ambiguity can

BUY	SELL	132.96	136.30
BUY	SELL	66.50	66.78
BUY	SELL	36.43	36.844
BUY	SELL	90.73	91.64
BUY	SELL	140.16	139.06
BUY	SELL	74.70	74.10
BUY	SELL	137.04	136.86
BUY	SELL	6.97	6.9405
BUY	SELL	29.07	28.6298
BUY	SELL	24.42	24.27
BUY	SELL	11.72	11.62
BUY	SELL	47.45	47.36
BUY	SELL	6.98	6.88
BUY	SELL	42.71	42.56
BUY	SELL	22.66	22.95
BUY	SELL	14.40	14.38
BUY	SELL	7.52	7.69

arise even in what may appear to be a rather definite valuation formula. For example, consider a valuation provision that dictates that share value be determined based upon asset book value less depreciation. In that formula does the amortization of purchased goodwill fall within the deduction for "depreciation"? Is depreciation of assets to be on a straight-line basis or to track the income tax methodology of the venture wherein there has been significant accelerated depreciation?

Assume A and B are each 50% members of LLC, and in Year 1 LLC acquires heavy equipment with a 15 year life for \$150,000 paid in cash. The entire purchase price, as provided in Code § 179, is written off in Year 1. In Year 2 B dies. Does the LLC have an asset of \$0 value or one of \$140,000 value? The very fact that reasonable minds could differ on those points demonstrates the ambiguity (and therefore the need for a legal interpretation) of the agreement at issue. Of course, this illustrates how important it can be for the agreement to specify whether book value is to be determined using GAAP, tax or some other methodology.

There can also be questions as to what exactly is being valued. While corporate stock is unitary where there is only one class of stock (*i.e.*, the economic rights and the right to participate in management are coincident with one another although these rights are easily separable by using separate classes of stock), an interest in a partnership or an LLC is often understood to have distinct economic and management components. To that end, a partner in a partnership may also have both a "transferable interest," being the right to share in the economics of the venture, and an "interest in the partnership," which is the transferable interest plus the right to participate in management. All too often agreements relating to partnerships and LLCs fail to recognize these distinctions and in the end provide for the valuation and

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acquisition of the right to participate in the economics of the venture but will not provide for either the valuation or the redemption of the right to participate in management. Drafting failures of this nature can lead to the curious situation in which a particular member's right to participate in the economics of the venture has been redeemed even as that same person retains the same right to participate in management that they had before the redemption transaction. Again, it is important that there be clarity as to exactly what interest is being valued.

Another issue that can arise is whether, irrespective of the clarity or ambiguity of the valuation methodology, the rights extend to someone not a party to the contract? First, assume that an individual is a business owner and for personal reasons has declared bankruptcy. The agreement, binding upon all the owners of the business, states that upon bankruptcy the corporation either may or shall redeem the shareholder's stake on a formula valuation. Setting aside the question as to whether that provision is at all enforceable by the corporation (it may violate the anti-*ipso facto* provisions of the Bankruptcy Code), will the bankruptcy trustee be bound by that valuation formula? Assume that the contractually set price is significantly below fair market value (however defined). A dispute may ensue in which the trustee argues that while the corporation is obligated to redeem the stock, it must, in doing so, pay an

objectively determined fair value and not the contractually agreed to price.

All too often, we are forced to consider what happens in the event of an owner's divorce. Assume Wife is a successful physician in a lucrative specialty. Husband is as well a professional, albeit one far less well compensated. During the periods when Wife was in medical school, performing her residency and subsequently developing her practice, she was supported by Husband. The various physicians in her practice have entered into a buy-sell agreement setting a relatively low value for the ownership stake in the practice, it being anticipated that nearly all earnings will be withdrawn as salary and benefits. While in the divorce Husband will not have a claim on Wife's professional credentials, he does have a claim for half of the value of her interest in that practice, it being a marital asset. Then comes the question as to its valuation. Wife will no doubt assert that Husband is entitled to no more than one-half of whatever value she would receive for the interest in the practice as provided for in the restriction agreement. He will assert that he is not a party to that restriction agreement and in consequence his recovery should not be limited by that contractually determined amount. There are court decisions which support each of these outcomes. Which of those positions is (more) correct will be entirely a question of law, but each of Wife and Husband, in their individual planning as the divorce becomes more likely,

needs to recognize that there exists the possibility that Husband's recovery will not be limited to one-half of the amount determined pursuant to a buy-sell agreement.

For a variety of reason, including maintaining the unity of ownership and management and for individual estate planning purposes, a buy-sell agreement is a highly recommended device in nearly all closely held businesses. It needs to be recognized that these agreements are entered into at a time when the constituent owners are on friendly terms, the business is often new and all parties are often optimistic. In turn, these agreements are applied at a time when the owners are at odds or have disparate objectives and are likely to disagree as to numerous points. Consequently, it is important that these agreements be clear and that they provide for a valuation that is certain, objectively determinable and normatively reasonable.



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