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FAIR VALUE™

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Do Professional Practice Buy-Sell Agreements Equal Fair Market Value? Part II- The Courts

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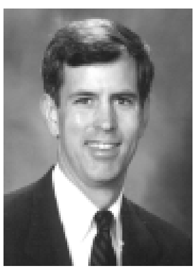
Introduction. One of the most frustrating areas of business valuation is the arena of family law and the many gray areas where market concepts of value and the case law do not necessarily coincide, or where the appraiser is left to interpret and apply what is sometimes vague case law to specific situations. While business appraisers are not attorneys, they are nonetheless forced into making legal interpretations in their valuations since the attorneys involved often cannot give clear-cut direction themselves. One common example of these ambiguities is the issue of how much weight, if any, business appraisers are to give in North Carolina divorces to existing shareholders' agreements in determining the fair market value of a divorcing professional's interest in a medical, dental, law or similar professional practice. This article will deal with the situations where these conflicts arise, the dilemmas they pose from a valuation standpoint, what case law says, and possible solutions. Those solutions will include a brief review of the first part of this series (Winter/Spring 2003 issue of *Fair Value*), which dealt with why the stated price in a buy-sell agreement often understates the true price to be paid, and set forth a framework for why and how the "hidden" part of the purchase price might be quantified where it exists.



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Background. In order to provide for an orderly transition and to control what happens to shares in the event a share owning professional decides to leave a practice, is terminated, dies, divorces or declares bankruptcy, virtually all professional practices will require shareholders to sign a shareholder (or buy-sell) agreement that dictates what happens in these circumstances. Although nothing is universal, most such agreements will typically provide for the following:

- **A Restriction on the Ability to Sell the Shares to Others-** If a shareholder has a third party offer to purchase the shares, agreements will usually provide for a right of first refusal for the Practice, and then other existing shareholders, to purchase the shares, either at the price and terms of the bona fide offer pending, or, more commonly, at a predetermined price or formula set price as established in the shareholder agreement. Alternatively, some agreements preclude any outside sale whatsoever.

- **Termination, Divorce, Bankruptcy-** This provision provides that in the event of termination (voluntary or involuntary), a divorce decree awarding the shares to the non-professional spouse, or bankruptcy, the shareholder must sell the shares back to the practice and/or its existing shareholders, typically at a predetermined price or formula price set forth in the agreement. The goal here is to avoid having the shares fall into hostile hands, such as an unhappy ex-spouse or a departing professional who may now be competing with the practice or left the practice on bad terms.

- **Death-** Like the above, if a shareholder dies, the agreement often establishes a pre-set or formula price at which the shareholder's estate must sell the shares back to the practice. In some instances, this price is higher than the price that would be paid in the event of termination, divorce or bankruptcy because the practice may have large life insurance policies on each of the shareholders.

While the formula pricing in these agreements is generally simple, deciding how to deal with their ramifications for fair market value in the divorce valuation context is complex and confusing. Usually, the problem comes down to how (if at all) the prices set for the shares in the shareholders' agreement impact the fair market value of the divorcing professional's shares in the context of a valuation for divorce purposes. If all practice shareholder agreements provided that the price to be paid was the fair market value of the shares as determined by an independent appraisal, then most of the divorce valuation problems would go away. However, this is usually not the case. Instead of a fair market value appraisal provision, the price to be paid per a shareholders' agreement is often set by one of the following types of mechanisms (or some variation thereof):

- **Accrual Basis Accounting Book Value-** Here, the price is based on the book value of the shares under Generally Accepted Accounting Principles (GAAP). This is simply the sum of all of practice assets less the sum of all of its liabilities (as of some set date), resulting in the shareholders' equity or "book value." Fixed assets, equipment, real estate, and so on are recorded at their original purchase cost, and then depreciated over time. If GAAP principles are followed, assets will include accounts receivable (usually a major asset in a professional practice), as well as all accounts payable and accrued liabilities.

- **Cash Basis Accounting Book Value-** This price is based on the book value of the shares on a cash basis. This is the same as the accrual basis accounting book value above but excludes accounts receivable and other accrued assets, as well as accounts payable and other accrued liabilities.

- **Variations of Book Value-** This is where the price is set based on one of a potentially limitless set of variations of the previous definitions of value. For example, the value may be determined based on the cash or accrual basis book value, but with real estate restated to its market value based on appraisals.

- **Set Price Per Share-** This involves a price that is set on a seemingly arbitrary basis or tied to some other measure. One common example is where the price to be paid is tied to the par value of the common shares. The departing physician who owns a 20% interest (5 shares) where the par value per share is $1.00 will therefore receive a token $5.00 for his or her shares.

Note that the above examples do not include situations where a shareholder agreement establishes the price to be paid by a formula tied to either a) the fair market value of the shares, based on independent appraisals, or b) measures that include other elements of value, such as goodwill. Although sometimes seen in professional practice shareholder agreements, these tend to be the exception rather than the rule. As a general observation, we at Banister Financial have tended to see these provisions occur more often in dental or orthodontic practices. Also, as a corporate market began to develop in the mid-1990s for the purchase of medical practices by hospitals and other health care delivery systems, some practices that had previously used book value types of formula provisions began to revise their agreements to bring market value concepts into the picture.

Formula Prices Often Fail to Capture Key Elements of Value. Already we can see some problems with the previous formulas and why they may bear no real relation to the true underlying value of a practice and its shares. First, on a book value basis, the equipment, real estate and other assets are recorded on a depreciating basis tied to their original purchase cost. This cost may bear no relationship whatsoever to the current market value of the assets at the time of the divorce. For instance, assume an orthopedic surgery practice purchases a building ten years ago for $1 million. This building now been depreciated down on the books to $700,000 at the time of the divorce. By contrast, the building's current market value has appreciated substantially to $2 million. Under the shareholder agreement, the formula says the departing professional will only get credit for the $700,000 value in the determination of the price of the shares. Therefore, an unadjusted book value formula can be woefully inadequate at capturing the real value of practice assets.

Second, accounting book value does not capture the value arising from any practice goodwill or other intangible value that may exist (e.g., the value of its client or patient base, customer lists, a skilled and trained workforce, reputation, and other factors). Goodwill, if it exists in a specific practice, is often the single most valuable asset of the practice to be sold. Throughout the late 1990s, for example, hospitals throughout the country paid very substantial prices to buy medical practices, of which a large portion of the total price was often for practice goodwill. The shareholders of those practices gladly sold at these high prices, irrespective of the fact that many of those same practices had buy-sell agreement formulas for departing shareholders tied to book value or some similar variation that was only a fraction of the price for which they sold the entire practice.

Third, cash basis book value formulas fail to capture what are often a professional practice's largest tangible assets- accounts receivable and unbilled work-in-progress. A hospital based anesthesiology practice, for instance, may have little or no equipment or real estate of its own, and its main assets on its books may be its cash in the bank and the accounts receivable due from patients. A two person law firm may have a few computers, desks and chairs, a law library, and a bank account which together amount to $50,000 or less, while receivables and unbilled work in process might be three or more times that.

In short, all of the above measures have real problems that may cause them to diverge very materially from presenting an accurate value of a practice or its shares.

But the Shareholder Agreement is Contractual and Therefore Binding… While the previous measures often fail at capturing what might otherwise be the true worth of a practice or its shares, the professional's attorney will present a different view. He or she will say that the shareholder agreement is a contract, willingly entered into by the shareholders, acting in their own self interest. The agreement sets the price that the shareholders will get and therefore is the fair market value, regardless of what other practices or practice interests sell for or what a business appraiser thinks they are worth in the absence of an agreement. To fail to take the provisions into account, we are told, is to ignore the reality.

But They're Just Planning for Their Divorces… On the other hand, the attorney for the non-professional spouse will maintain that the typical shareholder agreement in a professional practice is written in a self-serving manner to protect divorcing professionals in the event of a future divorce. To these attorneys, the agreement enables the divorcing professional to say something similar to following in depositions and in the equitable distribution hearing: "I only paid $5.00 for the shares and the shareholder agreement says that's all I will get if I leave the practice. That's the fair market value of my shares, not this goodwill mumbo jumbo that the appraiser says is an element of value." Furthermore, in some instances the professional will rattle off a list of the professionals coming and going from the practice, all of whom entered and left on this basis, as evidence that this is the true value per share.

So there you have it in a nutshell- the basis of the equitable distribution valuation debate, pitting the shareholders and their attorneys, who hide behind the agreement, and those who point to it as simply a device to get the divorcing professional off the financial hook of paying much to his or her ex-spouse.

North Carolina Case Law Regarding Shareholder Agreements. Given these diametrically opposed views, what do the courts say about the issue in the context of equitable distribution? In *Weaver v. Weaver* (72 N.C. App. 409; 324 S.E.2d 915; 1985), the valuation of a partnership interest in an accounting firm was at issue. The *Weaver* Court warned:

> "There is no single best approach to valuing a partnership interest. Our task on appeal, therefore, is to determine whether the approach used by the trial judge reasonably approximated the "net value" of the partnership interest."

The Court went on to describe how the partnership agreement's buy-sell formula worked in *Weaver*:

> "The plan first separates out the partner's capital account, which is the partner's equity in the firm, i.e., it is his share of the retained earnings, or undrawn profits, including cash accounts, receivables and equipment. The plan then derives a percentage, based on the partner's prior contribution to fees, and applies it to the profits earned over a five year span dating from the withdrawal date. Half of that amount is paid out to the partner in installments over the five years. This latter amount reflects the net value of defendant's interest in a going concern, that is, his share of the goodwill of the firm, as well as his share of the net value of work in progress."

The Court continues:

> "We agree with courts in other jurisdictions that goodwill is an asset that must be valued in equitable distribution of an interest in a going concern. See Stern v. Stern, 331 A. 2d at 261; In re Marriage of Nichols, 43 Col. App. 383, 606 P. 2d 1314 (1979); In re Marriage of Fleege, 588 P. 2d 1136 (Wash. 1979)."

In *Weaver,* the Court notes that partnership agreements may be of limited usefulness in calculating the value of an interest:

> "When the terms of a partnership agreement are used, however, the value of the interest calculated is only a presumptive value, which can be attacked by either plaintiff or defendant as not reflective of the true value. Stern, 331 A. 2d at 261."

In short, the *Weaver* Court warns practitioners that if the partnership agreement is not reflective of the true value (for example, if there is goodwill value and the agreement does not consider it), then the agreement is not necessarily presumptive as to value in the context of equitable distribution. In *Weaver,* the formula setting the price attempted to include goodwill in its calculation, unlike the earlier noted book value types of methods so commonly seen. Therefore, it appears that the Court would look very cautiously at the book value and arbitrarily set pricing types of formulas cited earlier.

The IRS and U.S. Tax Court Also Skeptical of Buy-Sell Agreements. The suspicion of buy-sell agreements as being self-serving documents in the values they set is not limited just to the North Carolina courts for family law, but extends to the valuation of businesses for estate and gift taxes as well. The concern by the IRS and U.S. Tax Court is that creative attorneys and their clients will use artificial formula pricing in shareholder agreements to attempt to depress the value of shares in closely-held businesses for estate and gift taxes. Because of perceived abuses in the area, Section 2703 of the Internal Revenue Code requires that business appraisers must disregard certain rights and restrictions in valuing such interests, including in buy-sell and shareholder agreements among related parties drafted or substantially modified on or after October 8, 1990. The impacts of such an agreement can only be considered if it meets the following three pronged test:

- It is a bona fide business arrangement,
- It is not a device to transfer property to family members for less than full and adequate consideration, and,
- It is comparable to similar arrangements entered into by persons in arm's-length transactions.

As a result, it may be very difficult for the closely held business owner who uses an arbitrarily set price (such as book value) or formula to have its impact respected by the IRS and U.S. Tax Court. Even when related family members are not involved, the U.S. Tax Court, in the *Estate of Lauder* (TC Memo. 1992-736), said that a shareholder agreement must meet the following four tests before it can be considered determinative of value for estate taxation purposes:

- The price must be fixed or determinable,
- The agreement must be binding on the parties during life and death,
- The agreement must have been entered into for a bona fide business reason, and,
- The buy-sell agreement must not be a substitute for a testamentary disposition.

Therefore, even when the parties are unrelated, the Tax Court looks at the provisions of buy-sell agreements with great suspicion.

Professional Practice Buy-Sell Agreements Do Not Always Tell the Full Story of the Price Paid. In the first article in this series ("Do Professional Practice Buy-Sell Agreements Equal Fair Market Value?," *Fair Value,* Winter/Spring 2003), I explained why in many cases involving a professional practice, the stated price for the buy-in and the buy-out of a shareholder in a shareholder agreement, taken solely on its face, without considering other elements, often significantly understates the "true" price paid for the practice interest at issue. In short, by focusing so narrowly on the buy-sell agreement, the attorneys and business appraisers may miss what is really going on.

A Hypothetical Buy-In Example: Let's briefly revisit the example given in the first article (available at www.businessvalue.com) of a buy-in arrangement that is fairly common in a professional practice situation and see why appearances can be misleading about the total implied value of the buy-in. This present article will not revisit all of the issues involved in quantifying the total implied buy-in cost, so readers interested in this should seek out the earlier article for a detailed discussion of the topic.

Assume that Dr. Jones, an orthopedic surgeon, joined a practice as an employee on January 1, 1997 and became a shareholder on January 1, 2000. Dr. Jones separated from his wife on January 1, 2003 and is now pointing to the $1,000 price he paid on January 1, 2000 as a direct indication of the value of his shares.

After graduation from medical school and the completion of a residency and then subsequent fellowship, Dr. Jones became board certified in orthopedic surgery and was now ready to begin the full time practice of his specialty. On January 1, 1997, Dr. Jones goes to work as an employee of Orthopedic Surgery, P.A. ("Practice"), a successful seven-physician practice providing orthopedic surgery services.

The buy-in deal was structured as follows: Dr. Jones would start work at the Practice on January 1, 1997, where he would work as an employee physician for three years. Unless he proved to be professionally incompetent or incompatible with the existing physicians, Dr. Jones was told he would be offered the chance to buy-in as a shareholder after three years, enabling him to purchase shares on January 1, 2000. At that time, he would buy a one-eighth interest (or a 12.5% minority interest) in the Practice for a cash payment of $1,000. During his three years as an employee physician, Dr. Jones would be paid $200,000 in annual salary, or $125,000 less than the shareholder physicians in the Practice, each of whom earned $325,000 per year.

A Hidden Buy-In Cost is Being Paid. Is the total implied buy-in price paid by Dr. Jones really $1,000, or is it something else? In this instance, as is often the case, the total implied price paid to become a shareholder is not simply the price paid for one's shares. The new orthopedic surgeon (Dr. Jones) is expected to work for a reduced salary for three years. Only after becoming a full shareholder in year four will Dr. Jones be compensated at a full salary equal to the other shareholders. Dr. Jones is paying a hidden, implied cost for the buy-in in the form of accepting reduced compensation until he becomes a shareholder at the beginning of the fourth year. Therefore, the total implied value (subject to some later caveats) of the cost of a buy-in is the sum total of the present value of the foregone compensation during the period as an employee physician, plus the $1,000 price actually paid for the shares at the point of the buy-in.

The present value of Dr. Jones' hidden buy-in cost (in the form of foregone compensation) is not simply $375,000 in total (or $125,000 foregone in compensation per year times three years as an employee, or alternatively, $10,417 foregone on a monthly basis). Dr. Jones did not become a shareholder immediately on day one, but instead had to wait three years to begin receiving shareholder level compensation. Had he received the $10,417 more in compensation per month by becoming a shareholder immediately upon starting with the Practice (rather than waiting three years), he could have invested the additional monthly compensation (from the greater compensation he could have earned immediately as a shareholder) and earned additional money. Thus, the present value of the foregone compensation is less than the stated $375,000 in total over the three years. How this present value can actually be quantified and used in the valuation process was examined in detail in part one of this series ("Do Professional Practice Buy-Sell Agreements Equal Fair Market Value?" *Fair Value,* Winter/Spring 2003).

Total Implied Prices Paid in the Buy-Out Process. Dr. Jones also says that if he leaves the Practice he will only walk-away with $1,000 (the price he will receive for his shares under the buy-sell agreement), "proving" again that this is all his shares are worth. But is this true? A review of the specifics tells a different story.

At the time a shareholder physician leaves the Practice, he or she receives payment for his or her shares at an amount as set forth under the Practice's Buy/Sell Agreement ("Stock Agreement"). Dr. Jones, who has now (on the valuation date of 1/1/2003) been with the Practice six years, bought into share ownership three years ago on January 1, 2000 and is also subject to this Stock Agreement. In addition, each shareholder physician leaving the Practice also receives deferred compensation payments under terms set forth in the Practice Shareholder Physician Employment Agreement ("Employment Agreement"). Dr. Jones is subject to an Employment Agreement dated January 1, 2000 (signed the date he became a shareholder).

The Stock Agreement indicates that departing shareholders are to receive a price of $1,000 for their shares (it is also common to see medical practices and other types of professional practices use a similar nominal amount or yardstick, such as accounting book value). Therefore, the total stated value for Dr. Jones' shares in the event he wished to sell them or leave the Practice would be $1,000. However, as is discussed in the following section, a deferred compensation arrangement also is relevant in determining the total implied price, which is greater than the stated price.

Deferred Compensation. According to the Employment Agreement applicable to Dr. Jones (and the other shareholder physicians), in the event of retirement (the definition of "retirement" in the agreement states that it does not have to be retirement in the sense one normally thinks of, but can include leaving the Practice for any reason, perhaps to join another practice), death or disability, a shareholder physician is entitled to a payment of deferred compensation computed as follows:

Fifty percent (50%) of the physician shareholder employee's average annual compensation (salary and bonus) received from Practice over the three (3) year period immediately preceding the occurrence of the event for which deferred compensation must be paid. Such deferred compensation shall be paid over a twenty-four month period, beginning on the first day of the month following the termination of employment."

Dr. Jones has now been a shareholder for three years (January 1, 2000 to January 1, 2003) and received shareholder compensation of $325,000 annually for each of those years, or an average of $325,000 per year. Under the above formula, upon terminating with the Practice, Dr. Jones would receive 50% (50% of $325,000, or $162,500) of his three year average compensation, or **$162,500,** paid in 24 equal monthly installments, without interest, of **$6,771** per month (rounded).

Therefore, since Dr. Jones is not paid deferred compensation immediately, but instead over 24 months, the present value of the proceeds is less than the stated amount due to the time value of money. Were Dr. Jones to receive the full payment of $162,500 at the time of departure, he could have invested the funds and earned additional interest. Instead, Dr. Jones has to receive the payments in installments, without interest, over 24 months. Therefore, in determining the estimated value of Dr. Jones' deferred compensation, per the Employment Agreement, the proceeds must be discounted to their present value on January 1, 2003, taking into account the time value of money.

Estimation of Deferred Compensation Due Dr. Jones Per Employment Agreement. It is now possible to estimate, per the Employment Agreement, the present value of the amount that was likely to be received by Dr. Jones for deferred compensation upon his departure from the Practice as of January 1, 2003. How this present value can actually be quantified and used in the valuation process was examined in detail in part one of this series ("Do Professional Practice Buy-Sell Agreements Equal Fair Market Value?" *Fair Value*, Winter/Spring 2003, available at www.businessvalue.com).

While Not a Part of the Buy-Sell Agreement, It is a Part of the "Deal". While the deferred compensation amount previously noted is not stated to be a payment for stock, it appears, in substance, to effectively be a part of the total consideration paid the departing shareholder physician, over and above the value of his or her shares under the previously noted formula (in this case, $1,000 for Dr. Jones's shares).

Why Part of the "Price" for the Shares Might be Paid in Deferred Compensation. As is often the case, tax motivated reasons are many times a driving force as to why professional practices choose to only pay a small stated amount for the shares (here, $1,000) in the buy-sell agreement, with the remainder called deferred compensation, a retirement benefit, or some other similar name. By calling the bulk of the payment deferred compensation, a practice attempts to deduct the bulk of the amount paid the departing physician for practice income tax purposes, reducing the after-tax cost of the buy-out to the practice. Therefore, professional practices have a strong incentive to structure buy-outs in a similar fashion and to hide the true nature of a large part of the stock purchase price by calling it something else, like deferred compensation. Also, structuring the payment over time allows the Practice to spread the cash flow impact to the Practice of buying out the shareholder.

Conclusion. Buy-sell agreements are looked upon with great suspicion by the courts as being potentially self-serving instruments, both in the family law and estate and gift tax realms. For equitable distribution purposes in North Carolina, the Appeals Court suggests that shareholder agreements are not necessarily conclusive as to value, particularly if they do not consider the presence of goodwill or intangible value. Clearly, book value types of formulas so common in shareholder agreements might fail to meet this requirement. Finally, regardless of whether a shareholder agreement does or does not consider goodwill value, attorneys and business appraisers should be skeptical and look for the "entire transaction," not just the portion of a price that may be visibly stated in the shareholder agreement. Methods exist, such as in my prior *Fair Value* article, which readily lend themselves to capturing the totality of the implied transaction value when this is the case. ♦

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