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BUSINESS VALUATION DIGEST

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Rise of the Going Private Transaction

Introduction

The IPO was once viewed as a significant milestone on the road to corporate success. Lucrative financing capabilities, superb stock liquidity, strong market visibility and maximized share value were all considered to be key advantages that public entities had over their private counterparts. But the post-Sarbanes Oxley world has ushered in a host of harsh new realities for public companies. Today, a public company and its management team must deal with arduous disclosure and filing requirements, intense public scrutiny, and significant liability risks. And the payback for all this trouble? Amidst the social and financial disasters of the past four years, the public stock exchanges in North America have taken a serious beating

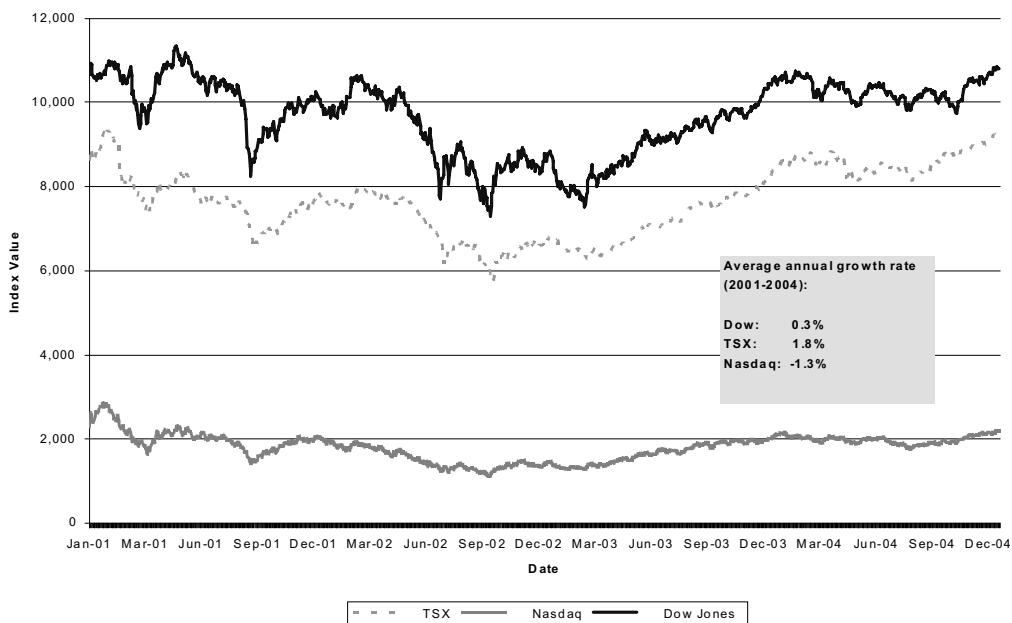
resulting in the devaluation and diminished liquidity of the securities of many small and medium-sized public companies.

The Myths and Realities of the Public Markets

The status of a public-traded entity has traditionally been viewed as being advantageous to a private corporation. Some of these perceived advantages include:

- Access to long-term capital;
- Increased market visibility and coverage;
- Increased stock liquidity;
- Maximization of stock value;
- Ability to offer stock incentives to key employees; and
- Prestige of public company status.

Performance of Major North American Public Market Indexes (2001-2004)



While some or all of these factors may be true for the small minority of large "blue chip" public firms, the majority of Canadian public companies are not realizing these so-called benefits.

In reality, there are many disadvantages and inefficiencies associated with a public market listing, including:

- Ongoing costs of meeting regulatory filing and disclosure requirements;
- Administrative costs related to publishing annual reports, conducting annual meetings, distributing shareholder proxy materials, etc;
- Diversion of key management focus (and time) from long-term growth strategies to short-term quarterly earnings;
- Increased public scrutiny and vulnerability to periodic market paranoia; and
- Increased income taxes due to ineligibility for reduced small business rates.

Further, the Sarbanes Oxley (SOX) era has forced additional costs and constraints on public companies such as:

- Significant time and costs associated with reporting on a company's internal control processes (SOX 404 in US); and
- Significant liability risk and rising insurance costs associated with the required certification of financial reports by company executives (SOX 302).

While the SOX regulations have initially focused only on SEC-registrants, Canadian regulators are quickly moving to follow suit. On January 16, 2004, the Canadian Securities Administrators (CSA) released the Investor Confidence Rules. These rules include Multilateral Instrument 52-109, which requires the CEO and CFO of a reporting issuer to personally certify annual and interim filings. In addition, the CSA is in the process of implementing an instrument that will require a report on management's assessment of internal controls over financial reporting.

Although costs differ significantly by company size, even smaller public companies

can expect to incur \$500,000 to \$1 million annually in expenses associated with the filing, disclosure and administrative requirements imposed by the public markets.

As a consequence of the factors noted above, there appears to be a growing incidence of *going private transactions*.

When Should a Public Company Consider Going Private?

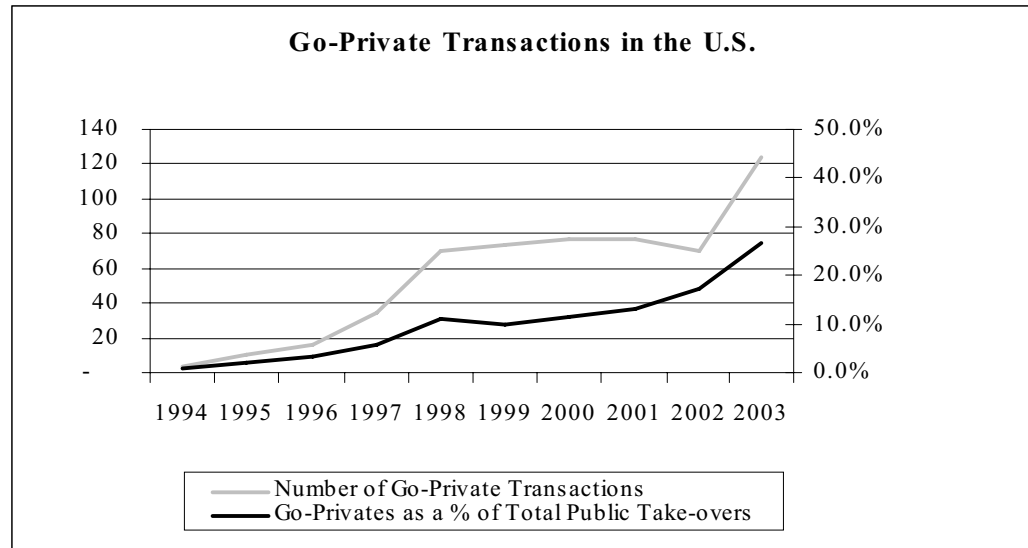
A public company should consider a going private transaction where the following conditions are present:

1. *Poor liquidity* – trading volumes for the company's shares are low
2. *Depressed stock price* – public share price is not reflective of fair market value
3. *Concentrated ownership* – majority of equity held by a small group of shareholders
4. *Strong business operations* – business operations are sound and outlook for the company is positive
5. *Quality management* – business operations are supported by an experienced and committed management team
6. *Access to financing* – management and/or controlling shareholders have access to available debt or equity capital to leverage the go-private transaction

Incidence of Go-Private Deals

In the United States, the number of going private transactions has skyrocketed in the last ten years. As the following graph shows, the number of go-private transactions in the U.S. increased from just 3 transactions in 1994 to 124 in 2003. In addition, go-privates as a percentage of total public take-overs increased from less than 1% in 1994 to nearly 27% in 2003:

In Canada, historical data relating to the number go-private deals is not readily available. However, a review of securities filings in recent years indicates that the incidence of going private transactions in Canada is on the rise. During 2004, we identified the following 14 go-private deals



#	Company	Former Stock Ticker	City	Description of Business	% of shares not owned by acquirer	Date of Go Private	Deal Value	Form of Transaction
1	Sutton Group Financial Services Ltd.	TSX:SUG	Vancouver, BC	Realty	29.50%	17-Feb-04	\$2,871,597	Amalgamation
2	Cara Operations Ltd.	TSX:CAO	Mississauga, ON	Restaurant operator	46.00%	25-Feb-04	\$338,182,182	Amalgamation
3	Arcis Corporation	TSX:RKS	Calgary, AB	Seismic services	83.00%	29-Feb-04	\$10,478,916	Take-over/Amalgamation
4	Pantorama Industries Inc.	TSX:PTA	Montreal, PQ	Clothing retailer	11.30%	1-Mar-04	\$1,452,276	Amalgamation
5	Mobile Climate Control Inds Inc.	TSX:MCC	Toronto, ON	Vehicle HVAC systems	31.80%	24-Mar-04	\$4,305,380	Take-over/Amalgamation
6	7 Crowns Corporation	TSXV:SCN	Edmonton, AB	Real estate operations	n/a	2-Apr-04	\$ 11,560,025	Special resolution/Consolidation
7	Voxcom Inc.	TSXV:VOX	Edmonton, AB	Security systems	9.00%	14-May-04	\$4,491,779	Special resolution/take-over
8	Anthem Works Ltd.	TSX:ANT	Vancouver, BC	Real estate operations	58.00%	31-May-04	\$25,695,653	Plan of arrangement
9	Motivus Inc.	TSXV:MOT	Toronto, ON	Marketing/communications	51.00%	8-Jun-04	\$361,158	Amalgamation
10	Canadian Bank Note Ltd.	TSX:CBK	Ottawa, ON	Lottery products/systems	27.00%	9-Jul-04	\$23,317,876	Amalgamation
11	Grilli Property Group Inc.	TSXV:GG	Montreal, PQ	Real estate development	14.84%	20-Oct-04	\$8,071,362	Amalgamation
12	Braden-Burry Expediting	TSXV:BBP	Yellowknife, NWT	Logistics services	47.25%	31-Oct-04	\$1,965,482	Amalgamation
13	Southesk Energy Ltd.	TSXV:SEE	Edmonton, AB	O&G investment firm	60.00%	30-Nov-04	\$1,478,250	Amalgamation
14	CML Global Ltd.	TSX:CNF	Calgary, AB	Investment firm	56.50%	8-Dec-04	\$9,659,167	Plan of arrangement

Source: Review of company annual reports, information circulars and news releases

Execution of a Go-Private Transaction

A go-private transaction is typically executed by way of an amalgamation, take-over bid, plan of arrangement or consolidation.

1. Amalgamation

Amalgamations are the most common approach to executing a go-private, occurring in over two-thirds of such transactions in Canada. An amalgamation involves incorporating a private numbered company to amalgamate with the public entity to form a new amalgamated private company.

To effect an amalgamation, the transaction must be approved by:

- i) at least 66 $\frac{2}{3}$ % of all shareholders of the company; and
- ii) greater than 50% of the minority shareholders (shareholders not affiliated with the acquiring group).

Upon amalgamation, shareholders of the public company often receive redeemable preferred

shares, which are typically redeemable for cash immediately following the completion of the transaction.

Amalgamation is generally the preferred method of effecting a go-private transaction as it does not necessitate that the acquiring group obtain 90% of the outstanding shares to successfully complete the transaction (as in a formal take-over bid).

2. Take over Bid

Take-over bids are the traditional method of effecting a change in control of a public company. Under this process, an acquiring company issues a bid for all of the shares of the target public entity.

A take-over bid is typically utilized to effect a go-private transaction when the public float is very large or the take-over is hostile in nature.

The difficulty in effecting a go-private transaction through a take-over bid process is

the requirement to obtain 90% acceptance from the public shareholders (excluding shares owned by acquiring group). As such, it is common for a take-over bid to be followed by a secondary transaction (usually an amalgamation) where the take-over bid is successful in receiving acceptance from greater than 50% but less than 90% of the shareholders subject to the bid.

3. Plan of Arrangement

A plan of arrangement is a court-sanctioned process of effecting a going private transaction. Under a plan of arrangement, an applicant private corporation applies to a provincial court for an interim order setting the ground rules for a transaction involving the public company.

A plan of arrangement usually involves a proposed acquisition of the public company by the applicant corporation. Typically, the interim court order would require that the arrangement be approved by:

- i) at least 66 $\frac{2}{3}$ % of all shareholders of the company; and
- ii) greater than 50% of the minority shareholders (shareholders not affiliated with the acquiring group).

Due to their preferential treatment under U.S. federal securities law, plans of arrangement are frequently used in cross-border transactions where the acquiring company is a foreign entity or where a significant proportion of the public float is held by foreign shareholders.

A key advantage of using such an arrangement (versus a take-over bid) is that the applicant corporation is able to acquire 100% of the shares of the public company by obtaining only 66 $\frac{2}{3}$ % shareholder approval. The major disadvantage of using a plan of arrangement in effecting a go-private is that such arrangements, by virtue of their reliance on the judicial process, tend to be more cumbersome and time consuming than other transaction forms.

4. Consolidation

The consolidation method involves the transformation of a subject company, by way of a special resolution of the shareholders, from a

publicly-listed entity to a private corporation.

Through a special resolution, the articles of incorporation of the company are amended such that the number of post-consolidation shares outstanding is reduced to a level below the distribution requirements of the public stock exchange.

To effect a consolidation transaction, the special resolution must be approved by:

- i) at least 66 $\frac{2}{3}$ % of all shareholders of the company; and
- ii) greater than 50% of the minority shareholders (shareholders who are neither related parties of the company nor acting jointly or in concert with related parties of the company).

Upon approval of the special resolution, the shareholders of the company receive post-consolidation shares in exchange for their current shareholdings based on a pre-determined formula. Where shareholders do not have sufficient pre-consolidation shares to receive full post-consolidation shares, there is typically a cash payout to such security holders at a pre-determined price.

The advantage of effecting a go-private transaction by way of consolidation is that there is no need to incorporate/amalgamate the operations into a new company. The challenge in using the consolidation method, however, is the likelihood that significant minority shareholders will be opposed to receiving shares in a private company due to the illiquidity of such securities.

Financing a Go-Private Transaction

Regardless of the mechanism chosen to effect a go-private, the most critical factor in successfully executing the transaction will be the acquirer's ability to finance the deal. Going private transactions typically involve the following types of acquirers:

- i) Majority shareholder(s);
- ii) Management;
- iii) Private equity; or
- iv) A combination of the above.

Due to the significant size of such transactions, the acquiring group will typically require external financing to complete a go-private. There are three primary types of external financing available to an

Type	Typical Source	Typical Cost	Collateral	Typical Term
Senior debt	Commercial banks	Interest (Prime + 2%)	A/R, inventory, capital assets	1 to 5 years
Subordinated debt / mezzanine funding	Subs of commercial banks, pension funds, mezzanine funds	Interest (Prime + 5%), equity kicker	Rank behind senior debt on all claims	5 to 10 years
Equity	Private equity groups, venture capital firms, buy-out funds	Equity ownership. Expect IRR of 20-40% (early stage company) or 10-15% (mature company, strong cash flows).	None	Exit plan of 3 to 7 years (early stage) and 1 to 5 years (later stage).

acquiring group: senior debt, subordinated debt/mezzanine funding, and equity capital, which are summarized in the table above:

While there are plenty of sources of financing available in Canada, the task of successfully attracting these sources to a specific deal should not be understated. External financing sources are much more likely to invest in a go-private transaction where the company has significant and predictable cash flows, an experienced and committed management group and a compelling business model.

Timing and Costs of a Go-Private Transaction

The time required to complete a going private transaction is dependent on many factors, such as the transaction structure and the ability to attract sufficient financing. A typical go-private transaction will require at least three to six months to execute and sometimes longer.

The costs associated with a go-private transaction can be significant and include the following:

- Debt placement and servicing costs;
- Management time and effort;
- Legal, accounting and advisory fees; and
- Filing, printing and administrative costs.

Excluding the costs of debt and management time, the expenses associated with a going private transaction are typically in the range of 1-3% of the total deal value.

Valuations and Fairness Opinions for Go Private Transactions

Professional valuers are frequently engaged by companies executing a going private transaction. Under the provisions set forth in OSC Rule 61-501, a formal valuation report must be prepared by an independent professional valuator for most going private transactions, insider bids, issuer bids and related party transactions (certain exemptions are available to micro-cap companies). Additionally, a professional valuator may be engaged by the Company's Board of Directors to prepare a fairness opinion to support the Board's recommendation of approval for a go-private transaction. The fairness opinion may be completed in conjunction with or separate from the 61-501 formal valuation report.

About the Author

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BY JOHN A. HATCH, PHD

Valuing Routine Intangible Assets

The valuation of intangible assets seems like a straightforward exercise. Most analysts either estimate their value via the income approach or via the cost approach. What is often ignored is that intangible assets can merely serve to maintain historic levels of cash flows. That is, in some cases, the development of an intangible asset, or more generally the possession of an intangible asset, does not provide the developer/owner with a competitive advantage in the market place, but merely prevents the company from being at a competitive disadvantage.

We refer to such intangibles as “routine” – most firms within the industry will possess a similar intangible (otherwise the small subset that does would reap some competitive advantage). If you think about the cash flow generating capabilities of a company as the water level in a tub, a routine intangible asset can plug the drain and prevent the water level from dropping, but it does nothing to add to the water level; for that you need a spigot. When an intangible asset is routine, the development of that asset may not lead to any increase in the market value of the invested capital, but it can prevent a decrease. Such an asset has a clear and identifiable value to the company, and the need to develop it in the first place suggests that *other assets of the company*, in the absence of the development of the cash-flow maintaining intangible, would be impaired in value.

This is clearly an issue when a company is acquired, and the acquirer has to account for the acquisition under the purchase accounting methods prescribed in FAS 141 and 142. Most of the current assets of the company will have a value that is independent of the long-term prospects of the business (as reflected by an income approach), so the clear candidate for a reduction in recorded value would be net property plant and equipment. When the acquired property plant and equipment is not going to be sold by the acquirer, but is instead going to be used, it must be valued at “the current replacement cost for similar capacity

unless the expected future use of the assets indicates a lower value to the acquiring entity.”¹ This suggests that, if the plant and equipment are not capable (on their own) of generating cash flows that meet or exceed their replacement cost, their value may be determined as less than their estimated replacement costs.²

In declining industries, or where the physical capital required is special purpose in nature, often the physical assets have a value-in-use that is less than their replacement value. In such industries, as competitive pressures intensify and margins and cash flows get squeezed, the value-in-use of the physical capital continues to decline. In some cases, companies are effectively able to curb the decline in cash flows through developing routine intangible assets, such as processes or plant improvements that lead to reduced costs. We refer to such assets as cost-saving intangible assets. Because of the extreme degree of competition in industries of this nature, consolidations through acquisitions are not uncommon, nor are Chapter 11 bankruptcies and subsequent emergences. Whether a company has recently been acquired or it is emerging from bankruptcy, the physical capital and the routine cost-saving intangibles need to be valued for financial statement reporting purposes. In such circumstances, replacement costs may not be relevant in valuing the plant and equipment, and instead the valuation of the plant and equipment should be done concurrent with the valuation of the cost-saving intangible.

But even when you concurrently value routine cost-saving intangibles and net PP&E, the proper post-acquisition purchase price allocation may not be straight-forward, as several different options may be defensible given certain facts and circumstances. Specifically, when the acquiring company already possesses the routine intangible asset owned by the target company, as is often the case, there are three potentially justifiable purchase price allocations under FAS 141.

The Model

Consider the following model defined by four assumptions:

1. The subject company is in a perfectly competitive industry, wherein all firms charge the same price for one commodity good;
2. All companies in this industry are identical, and the typical firm has a market value of assets currently equal to \$100, exactly equal to the book value of its tangible assets.³ (In addition, there is equality between book and market values for each individual asset). Assume that the book value of property plant and equipment is initially \$60.
3. Each company in the industry sells 1 unit of the good each year, and generates \$10 in cash flow each year. There is no growth in the industry. The discount rate is 10 percent (hence the \$100 market value of assets).
4. We assume that the company dividends its entire cash flow each year, and is financed entirely by equity.

Table 1 below shows expected cash flows for a company in the industry, given the current state of technology.

Now consider what happens if a new technology becomes feasible in the industry, and possession of the technology lowers the marginal production costs by \$1 (from \$50 to \$49). Because the industry is perfectly competitive, if the marginal production

cost of each firm were to improve by the same amount, there would be an increase in supply that would cause a reduction in price equal in size to the marginal cost reduction. Thus, if all firms reduce their marginal costs by \$1 per unit, the price for the good would fall by \$1. The consumer would reap all of the benefits of the improved cost conditions in the industry.

But in order to implement this new technology (which is itself free), a company in this industry has to make a \$5 investment in R&D that will, with certainty, result in a \$1 reduction to its marginal production costs. Because the industry is competitive, if all companies make the investment, the price of the commodity will drop by \$1. The expected cash flows (gross of the investment in the new machine) for each company will not change as a result of the investment if all companies make the investment.

As a result, absent making the \$5 investment in the new machine, a company faces a \$1 reduction to its annual cash flows, which would fall to \$9 (under the assumption that all other companies in the industry purchase the machine, and the market price falls accordingly).

The market value of the company's assets would fall to \$90, as shown in the Table 2 on next page..

Table 1

Discount Convention: End-of-Year								
Discount Rate	10%							
Year	1		2		3		4 Terminal	
Revenues	\$	100	\$	100	\$	100	\$	1,000
COGS	\$	50	\$	50	\$	50	\$	500
SG&A	\$	40	\$	40	\$	40	\$	400
New Financing	\$	-	\$	-	\$	-	\$	-
Investments	\$	-	\$	-	\$	-	\$	-
Changes in WC	\$	-	\$	-	\$	-	\$	-
Cash Flows	\$	10	\$	10	\$	10	\$	100
Discounted Cash Flow	\$	9.1	\$	8.3	\$	7.5	\$	68.3
Value	\$	100						

Table 2

Year	1	2	3	4	4
Revenues	\$ 99	\$ 99	\$ 99	\$ 99	\$ 990
COGS	\$ 50	\$ 50	\$ 50	\$ 50	\$ 500
SG&A	\$ 40	\$ 40	\$ 40	\$ 40	\$ 400
New Financing	\$ -	\$ -	\$ -	\$ -	\$ -
Investments	\$ -	\$ -	\$ -	\$ -	\$ -
Changes in WC	\$ -	\$ -	\$ -	\$ -	\$ -
Cash Flows	\$ 9	\$ 9	\$ 9	\$ 9	\$ 90
Discounted Cash Flow	\$ 8.2	\$ 7.4	\$ 6.8	\$ 6.1	\$ 61.5
Value	\$ 90				

Investment Financed Out of Cash Flow

Now assume that the company has plans to make the \$5 investment in the next year, which it will finance from cash flows earned during the year the investment is made. In this case, dividends in the first year will fall by \$5, causing the current market value of the company to fall (based upon anticipation of the investment) by the present value of \$5, since all other cash flows remain unaffected. Using an end-of-year discounting convention, the market value of the company is \$95.45. This is shown in Table 3 below.

on its books. If we add a \$5 book value for the cost-saving intangible to the existing book numbers, we have \$105 in assets, which exceeds the purchase price for the company (\$100).

Purchase Price Allocation

Given that our sample firm above has been acquired for \$100 the year after it invested in the cost-saving intangible asset, what is the proper purchase price allocation among the assets of the company? Three different possible allocation options are shown in Table 4 below.

In each of the options presented above, the

Table 3

Year	1	2	3	4	4
Revenues	\$ 99	\$ 99	\$ 99	\$ 99	\$ 990
COGS	\$ 49	\$ 49	\$ 49	\$ 49	\$ 490
SG&A	\$ 40	\$ 40	\$ 40	\$ 40	\$ 400
New Financing	\$ -	\$ -	\$ -	\$ -	\$ -
Investments	\$ 5	\$ -	\$ -	\$ -	\$ -
Changes in WC	\$ -	\$ -	\$ -	\$ -	\$ -
Cash Flows	\$ 5	\$ 10	\$ 10	\$ 10	\$ 100
Discounted Cash Flow	\$ 4.5	\$ 8.3	\$ 7.5	\$ 6.8	\$ 68.3
Value	\$ 95.5				

By financing the investment in this fashion, there is no change on the balance sheet, and the book value of assets remains at \$100. Once the company moves beyond the investment year, the market value of the company rises back to \$100, equal again to the book value.⁴

Now suppose this company is acquired 1 year after the investment is made for the market value of its assets (\$100). The company has \$100 of assets recorded

current assets have a market value consistent with their book value, by assumption.

Table 4

	Option 1	Option 2	Option 3
Current Assets	\$40	\$40	\$40
Net PP&E	\$50	\$50	\$60
Cost-Saving Intangible	\$5	\$0	\$0
Goodwill	\$5	\$10	\$0
Total Assets	\$100	\$100	\$100

The Case for Option 1

The value of the cost-saving technology via the cost approach is \$5. This assumes that there are no legal barriers that prevent a hypothetical buyer from developing the same intangible (or one of equal utility). Because the cost-saving technology saves the company \$1 in costs that it would otherwise face, there is a \$10 benefit (gross of development costs) to making the investment. Because the value under the cost approach is less than the value of the asset under the income approach, it is clear that each company will make the investment, and that no company would pay more than \$5 in exchange for the asset. Therefore, \$5 is the appropriate amount to record on the balance sheet.

What about the net PP&E? From Table 2, we know that in the absence of the cost-saving intangible asset, but in combination with the current assets of the company, the value of equity would be only \$90. Again, the book values of current assets are by assumption equal to their market values, at \$40 in the aggregate. This implies that the proper value to record for the Net PP&E is \$50.

The sum of the values for these three assets – the cost-saving intangible, the current assets, and the Net PP&E, is \$95. Because the market value of total assets is \$100, this leaves \$5 to be booked as goodwill.⁵ This is one way in which goodwill can arise: the cost to develop a non-proprietary intangible asset is less than the income produced by that intangible.

The Case for Option 2

Now consider the following question: if the acquiring company is in the same industry and possesses the same cost-saving intangible asset that is owned by the target, is the purchase price allocation above still correct? Before answering that question, I should dismiss the argument that the price for the target company would change under these conditions. One might argue that the acquiring company would not pay as much as \$100 for the target if it already possessed the intangible asset, and would instead only pay \$95. The resulting purchase price allocation would then be as above, but with the removal of the \$5 recorded value for the cost-saving intangible asset.

But this is incorrect. The buyer, already with possession of the intangible asset, knows that in combination with the current assets and the Net PP&E of the target, he can generate \$100 in value. The buyer, whether or not he plans to use the acquired intangible or his own equivalent intangible, knows that he can generate \$100 in value, and is willing to pay up to that amount. And the seller is not willing to sell for less than \$100. Because the intangible asset is a non-rivalrous asset (i.e. it can be employed in a new plant without diminishing its employment in an old plant), there is no opportunity cost faced by the buyer in using its intangible in combination with the newly acquired assets of the target, so the buyer is *willing* to pay \$100. Any transaction that takes place must take place for \$100 (assuming that this is less than the replacement cost of the Net PP&E and the market value of the current assets combined).

As before, \$40 is estimated as the market value of the current assets, leaving \$60 to be allocated between Net PP&E, the cost-saving intangible, and goodwill. The remaining allocation assigns \$50 to the Net PP&E, and \$10 to goodwill. The \$10 in goodwill arises from the fact that the buyer can combine its own intangible assets with the current and fixed assets of the target to generate \$100 in value, whereas in the absence of being able to combine these assets, the newly acquired assets would only generate \$90 in value. The difference, because it stems from the assemblage of assets, is conceptually part of goodwill.

This method has intuitive appeal due to the fact that it places no value on the acquired cost-saving intangible asset, which is consistent with the fact that the value of that asset does not figure into what the *purchaser* is willing to pay for the company. But there is a problem, because the asset does figure in to what the seller *requires* as minimum payment. If the seller did not currently possess the intangible asset, but plans to

make the requisite investment in the coming year, from Table 3 above, we know that it would be willing to sell for any price at or above \$95.45. The fact that the seller already possesses the intangible increases the minimum price it will accept up to \$100.

Despite the fact that buyer has no use for the intangible asset, we could view the buyer as effectively having to purchase the intangible at its fair market value of \$5. So both allocation Options 1 and 2 appear defensible.

The Case for Option 3

Finally, consider a slightly different transaction. Instead of the buyer acquiring the equity of the target company, suppose that it directly purchases the Net PP&E of the target in an asset deal. Again I assume that the buyer already possesses the cost-saving intangible asset. By the same logic used above, the purchase price for the PP&E would be \$60, and it would be reflected on the balance sheet of the acquirer exclusively as a purchase of PP&E. No goodwill or intangible asset values would be recorded because the transaction is for one asset. If one were to take the view that the form of the transaction should not affect the accounting for the transaction, then one could view the purchase of equity as equivalent to a direct purchase of the current assets and net PP&E of the target. This would suggest purchase price allocation Option 3.

Conclusion

Routine cost-saving intangible assets are valuable, as they are not costless to develop and they prevent declining cash flows that the company would otherwise face. When a company of this nature is acquired, the permissible allocations of net asset value to the respective assets that comprise the company may be contingent upon the type of buyer. If the buyer is inside the industry (i.e. a horizontal merger), each of the three allocation options discussed above has some appeal. If the buyer is outside the industry, Option 1 would appear to be the best of the three.

Though the example presented in this article focused upon routine cost-saving intangible assets, the same logic might apply to routine demand-enhancing intangible assets. For example, some investment in advertising may be required by a firm to maintain existing cash flows, and the investment may not be expected to do anything more than just that. Likewise, some companies have great brand recognition from a long history, but while the brand no longer carries any ability to command a premium in the market, it might serve as a tie-breaker, after price, that helps the company maintain high capacity utilization.

The example also highlights the fact that, once it is determined that the fair market value of the company's PP&E is likely beneath its replacement cost, though that PP&E is absolutely necessary for ongoing operations, the ownership of, or subsequent investments in, routine intangible assets may be needed to keep the company viable.

When a company possesses a non-routine intangible asset, defined as one that is unique to the company and confers a competitive advantage to the company, that asset would need to be explicitly recognized at its fair value in the resulting purchase price allocation, regardless of the characteristics of the buyer.

Endnotes

1. Paragraph 37(d)(1) FAS 141.
2. For assets in which a used-asset market exists, the replacement cost for the asset can be determined directly from this market. Obviously, if the company plans to retain the newly acquired assets, it expects that their value in use is at least as great as the used asset-market price for the same assets. But in many cases, where acquired plants and equipment constitute special purpose capital, there will be no used asset market, and the resale value of the capital may be a nominal scrap value. In such cases, it is very possible that the value-in use of the asset is less than the replacement cost, but because the initial costs to acquire the asset are sunk, the business continues operating with those assets as long as the value-in-use exceeds the scrap value.
3. I assume, for the sake of simplicity, that the company has no current liabilities, so that the market value of assets is equal to the market value of equity.
4. We would get a similar result if the company received new financing to fund the investment, and maintained its dividend at \$10, and its cash balances at their historic level. Here, there would be an increase in either debt or equity on the right side of the balance sheet, but there would also be a corresponding reduction in retained earnings. As a result, the book value of the assets would remain equal to the market value of the assets at \$100. No other forms of financing – such as sale of excess assets – are considered here, as the company is assumed to possess no excess assets.
5. Here, goodwill stems from the combination of the net assets of the company. The Net PP&E by itself is worth only \$50, and the cost-saving intangible is worth only \$5. But the two in combination with each other are worth \$60, \$5 more than the sum of their stand-alone values.

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Valuation Aspects of Shareholders' Buy-Sell Agreements

One of the most important aspects of a shareholders' agreement is often the buy-sell clause, the purpose of which is to provide a market and liquidity for the departing shareholder's shares and a manner or mechanism in which the continuing shareholders¹ may purchase those shares in circumstances where any one of the following "triggering" events applies to that shareholder:

- Death;
- Mental or physical disability or bankruptcy;
- B-2/Bankruptcy
- Voluntary cessation of employment (retirement);
- Involuntary cessation of employment (dismissal);
- Dissension or deadlock among the shareholders;
- Criminal conviction;
- Matrimonial property claim; or
- A desire to sell the shares and withdraw from the company in order to form one's own business.²

The funding aspect is intended for the departing shareholder to be protected as to the selling price agreed to in the buy-sell clause, and the continuing shareholder(s) to not be subject to an undue strain on their liquid resources. Such funding is usually by way of life insurance. In summary, the buy-sell provisions of a shareholder's agreement are meant to achieve a number of objectives:

- There will be an assured market as well as a fair selling price to the terminating shareholder for his or her shares as a result of death, a falling-out, or an inability to continue in the business.
- In the case of death, a vehicle exists that will assist in the timely administration of the deceased shareholder's estate.
- There will be increased certainty for estate planning purposes as to both quantum and

liquidity with respect to the deceased's shares.

- Control of the corporation by the remaining shareholders is assured, without the involvement and possible interference of outsiders who might otherwise acquire the terminating shareholder's shares.
- A fair purchase price and a mechanism for the interest acquired by the continuing shareholder(s) is obtained.

Sale prices, terms of payment, etc. may vary depending upon the particular specified event or even the relationship among the shareholders. For example, a different purchase price may be offered, upon the death of a shareholder, to the continuing shareholders than would otherwise be the case upon withdrawal or termination. Whether the majority shareholder should be a party to such an agreement may also be questionable and may depend upon whether that shareholder plays an essential role in the company's operations.

The provisions of a buy-sell agreement must be designed to provide liquidity and fairness to a shareholder who withdraws from the business or dies, as well as to permit management and ownership to continue without interference from outside parties. The following are questions that must be addressed in drafting a shareholders' buy-sell agreement:

- Depending on the jurisdiction, is a shareholders' agreement at all possible?
- Should the *controlling* shareholder be party to the agreement?
- What specific events or circumstances should trigger the requirement for particular shareholders to buy or sell shares of the corporation?
- If a shareholder ceases to be employed in the company, should he or she be required to sell his/her shares?
- Must the shares be sold upon death? If so, will any potentially available tax savings be safeguarded?
- How should the buy-sell clause be funded when the specified event is death?
- Should there be a forced buy-sell ("shotgun") arrangement, or should there be a right of first

refusal granted to the continuing shareholders? If so, should that right be granted to all or only some (or one) of them?

- If there is a requirement for a shareholder to sell, must the shares be offered to the other shareholders in proportion to their respective shareholdings, or should there be some other order of priority?
- What treatment should be accorded a minority shareholder when there is an arm's-length, third-party, bona fide offer for 100 percent of the outstanding shares of the company? Should he/she be given the opportunity of acquiring the controlling (majority) shareholder's shares under the same terms and conditions contained in the third-party offer?
- What time limit should be set for the majority shareholder to sell the controlling shares to the third party if the right of first refusal is not exercised by the minority shareholder?
- How will price and value be determined? As of what date? For example, should price and value be computed as of the date of the specified event? As of the end of the immediately preceding month? As of the end of the last completed fiscal year of the company? Or as of the end of the last regular reporting period (such as a quarter) for accounting purposes?
- Should the corporation redeem/acquire the shares or should the remaining shareholders, and what would be the different tax consequences?
- What are the tax implications if the vendor is a non-resident?
- How will any non-compete payments and/or consulting fees be addressed?

Valuation Aspects

The foregoing are only a few of the numerous questions that must be addressed in a shareholders' buy-sell agreement. Equally important are the valuation aspects relating to the shares that are subject to the agreement.

Shareholders' agreements are reduced to writing only after the intentions of the parties have been considered. When the buy-sell clause is triggered, however, problems may still arise because relationships and circumstances may have changed, or because there are inadequate instructions in the agreement for

establishing how the terminating shareholder's interest is to be valued. For example, many agreements provide for the buy-sell price to be simply at "book value" – which, for the reasons outlined below, can cause serious inequities and distorted results. Also, as well be seen, even the term "fair market value" can have material shortcomings in the context of a buy-sell. These are discussed below. Buy-sell agreements often share a common failing:

"Almost by definition the setting of a value for a business to be covered by a buy-sell agreement is an essential feature of that agreement. Too often it is also the most neglected feature of the agreement, set in an arbitrary, unprofessional manner almost as an afterthought."³

The practical problems in attempting to establish a fair and reasonable price in a buy-sell clause are the uncertainty as to the type of event (death, dismissal, incapacity) that will occur and thereby trigger the provisions of the clause, and the timing of such an occurrence.

Setting the Price

In any buy-sell clause, the transaction price between the terminating and continuing shareholders must be clear and readily ascertainable. The following are the usual methods for determining price under a buy-sell agreement:

- Fixed price negotiated in advance by the parties and updated periodically (usually annually) and used for a specified event occurring subsequently.
- Price determined by an independent third party, such as an accredited business valuator.
- Price established by formula.
- Price determined pursuant to a shotgun (put-call) clause.
- Price established by right of first refusal.

No single approach to the problem of establishing a price under a buy-sell agreement will be entirely satisfactory to all parties and address all situations. As will be explained below, none of these five alternative price-

setting mechanisms is totally satisfactory. Furthermore, regardless of the method agreed upon, difficulties in the interpretation of the price/value term (or standard) employed in the agreement may be encountered. My comments address some of the problems that are often encountered in the various price-setting mechanisms.

Many buy-sell agreements that are prepared (often by attorneys) without having adequate valuation input employ the term "book value", "fair market value", "market value", "fair value", "value", or some other term the implications of which are rarely given much thought. Of course, each of these value terms (standards of value) can lead to different valuation conclusions.

Since "book value" and "fair market value" are the price/value terms most frequently employed in buy-sell clauses, the comments that follow will highlight some of the potential problems that accompany their use.

Use of "Book Value"

"Book value" (which would generally be at historical cost) may be totally inappropriate in determining price in a buy-sell agreement and unfair as a basis for the acquisition of the terminating shareholder's shares. Either the continuing shareholder(s) or the terminating shareholder will be unfairly treated if the buy-sell price is book value (except perhaps in portfolio investment-type situations).

"Book value" is defined as "the amount at which an item appears in the books of account and financial statements; in connection with owners' equity in a business, the amount of the net assets of the business shown in a balance sheet."⁴ The term "book value per share" is defined as "the portion of the shareholder's equity attributable to a share of issued capital of a corporation, taking into account the participating rights of the various classes of capital stock outstanding."⁵ Stated differently, book value is the net amount of assets as shown by the books, or the amount that the shareholders will receive immediately following a no-loss liquidation.

If the buy-sell clause employs the term "book value," payment to the withdrawing or deceased shareholder at such a price may be substantially below a fair and reasonable amount because, of course, increases in the values of fixed and certain other assets and the existence of valuable intangibles, including intellectual property, generally will not be recognized in the calculation of book value. This is because tangible assets are generally recorded at original or historical cost, and intangibles, unless they are either purchased or there has been a business combination, will not even be reflected on the face of the balance sheet. Nor are contingent assets and liabilities reflected on the balance sheet; they commented on in the notes accompanying the financial statements.

"Book value" has several other important shortcomings when it is used for purposes of setting the buy-sell price. Consider the result in each of the following unrelated hypothetical situations:

- A business has substantial earning power, and goodwill is not reflected on the balance sheet. Moreover, the terminating shareholder was instrumental in creating and maintaining the goodwill.
- A business is construction-related (a construction company, a firm of architects, etc.) and has long-term construction contracts. The firm recognizes its profits using the completed-contract-method of accounting rather than the percentage-of-completion method. Over 90% of the work has been completed but, adhering to the firm's consistent accounting policies, revenue recognition will not occur until after the shareholder departs.
- Future income taxes payable are reflected on the company's balance sheet. For valuation purposes, depending upon how such tax credits arise, should they be considered a liability or a part of shareholders' equity in computing book value per share?
- The company has large unused loss carryforwards (which have substantial value), but the related losses for accounting purposes have a negative effect on the calculation of the book value of the company's issued shares.
- There are various *potential* liabilities (distinct from contingent liabilities) such as letters of credit available but not yet presented to or paid by the bank, environmental considerations, etc.

- During the intervening period there was an issue of common stock from treasury at a price in excess of book value; retirement of preferred stock at a price below the book value of the preferred; conversion of funded debt into common stock; issuance of stock dividends; a stock split; or a reverse stock split.
- At the time of the signing of the agreement, the circumstances were different from those prevailing when the triggering event occurs.
- Accounting policies such as the capitalization of certain repairs or the treatment of depreciation, etc. have not been consistent from year to year since the signing of the buy-sell agreement.
- There have been errors in the preparation of the current year's or the previous year's financial statements.
- The company is on a cash basis of accounting rather than on an accrual basis.
- There are pending lawsuits or substantial claims by or against the company (referred to in the notes to the financial statements), and it is impossible to determine their potential outcome. In addition, the company has just been reassessed for the previous taxation year for a substantial amount, believes that the reassessment is ill-founded and will file an objection.
- The company has consistently excluded overhead from its inventory. Had such normal overhead been included, retained earnings would have been increased (net of income taxes on such overhead).
- There are inventory and other hidden reserves.
- The company's balance sheet reflects purchased goodwill which has lost value since acquisition and has not yet been written down pursuant to the annual impairment test under GAAP⁶
- Transactions between the company and non-arm's-length parties have taken place at other than fair market value.
- There are "special purchasers"⁷ in the marketplace.
- The specified event is death, and life insurance proceeds will be payable to the company as beneficiary and owner of the policy.
- The company is the guarantor of bank loans to a third party.
- There are product warranties outstanding which have not been booked (but only noted) on the financial statements.

- There is long-term debt owing to arm's-length creditors, but bearing interest at rates substantially below current market rates on similar obligations.

The pitfalls of using book value for the transaction price can be best summarized in the words of Professor James C. Bonbright in his valuation treatise:

"Needless to say, an inference that the market value or "fair market value" of a share is equal to its book value must be based on a whole series of assumptions, each of which is more likely than not to be unwarranted in a given case. First, the books may be inaccurate from an accounting standpoint, with the result that the book value is an *improper* book value. Second, good accounting practice itself does not purport to require that assets be "valued" at their *value* in any accepted sense of the word. Instance the traditional rules that fixed assets should be valued at depreciated actual cost, that inventories may be valued at \$1 unless it was acquired by purchase. Third, the assumption that the stock equity as a whole is worth the difference between the value of the gross assets and the par values of the liabilities is often quite unjustified. And fourth, the further assumption that the value of any given number of shares of stock is worth a *prorata* portion of the value of the entire stock equity is frequently erroneous."⁸

In summary, although "book value" may be the simplest term to understand - and to calculate - it will often yield unfair results.

To avoid potentially serious inequities, the term "adjusted book value" might be considered, which contemplates that the assets and liabilities are adjusted to their fair market values. But only those that are recorded on the balance sheet? The International Glossary of Business Valuation Terms recognizes this potential problem in its definition of "Adjusted Book Value Method":

"a method within the asset approach whereby all assets and liabilities (including off-balance sheet, intangible, and contingent) are adjusted to their fair market values (NOTE: In Canada on a going concern basis)."⁹

Fair Market Value

In view of the types of problems and various inequities described above, some practitioners have preferred the use of the term "fair market value" in the buy-sell clause.

Assume that a terminating shareholder holds a minority interest. If the agreement provides that he or she be paid fair market value upon the triggering event, the first question that comes to mind is whether, and to what extent, a discount should be applied in determining the fair market value of the minority shareholding.

In the absence of any other particular instruction or direction, an accredited valuator will follow accepted valuation practices, principles and standards, and, if appropriate, might apply a minority discount to the pro-rata value of the terminating shareholder's interest, as well as a marketability discount to the resulting base (i.e., to the "as-if-freely-traded value").

Other potential problem areas are created by employing the "fair market value" standard without any further direction to the valuator. For example:

- In the absence of specific instructions, does the valuator, take into account the loss to the company of the terminating shareholder's future services?
- How is corporate-owned life insurance to be treated, when the company is the beneficiary?

In valuing the company's issued shares, does the valuator include goodwill that may otherwise be considered as belonging to the continuing shareholder who was the key person? The valuator may be faced with the continuing majority shareholder's argument that the goodwill should not be included because the majority shareholder was

responsible for most of the company's business and thus such goodwill belonged to him and was personal. In a U.S. case that addressed this issue, it was held that "the goodwill of a business carried on by a corporation belongs to the corporation alone."¹⁰ In a Canadian case, the valuator's report was successfully attacked because no consideration was given to goodwill.¹¹

Also, the buy-sell clause should instruct the valuator to consider the terminating shareholder's interest, for valuation purposes, as part of the controlling group having 66% of the votes in all circumstances. If the agreement employs the term, "fair market value", it should specify "without the application of either a minority discount or marketability discount", if that is what is intended.

Date of Calculation

For purposes of discussion, assume that book value is acceptable (because the company is an investment holding company). The shareholders' agreement may, however, fail to indicate the date as of which book value is to be determined. For example, assume that book value is to be determined as of the last completed fiscal year-end for which there are audited financial statements (December 31). If the specified event (say, dismissal) takes place the following November - some 11 months later- is it fair to calculate the book value of the terminating shareholder's interest as of last December 31? Consider the position of a terminating shareholder of a major department store who departs before the Christmas season and who is required to accept book value calculated as of 11 months earlier, or of an automobile or pleasure-boat dealership who departs March 31, just before the high season.

Other questions that must be addressed include whether the interim statement is to be audited, and, if so, who bears the cost?

Advantages and Disadvantages of Price-Fixing Mechanisms

The following comments outline certain advantages and disadvantages of each of the various price-setting alternatives discussed earlier.

Fixed Price Determined Periodically

When a fixed price is determined periodically, the shareholders themselves, who usually have the best idea as to the value of their company, negotiate in

advance a price at which the shares of the departing shareholder will transact when a specified event is triggered. That price is updated periodically by the shareholders in order to take current factors into account.

Advantages

In general, a current fair market value is maintained if the periodic setting of the price value is adhered to.

Disadvantages

While there is usually provision for the parties to meet each year to establish a new (up-to-date) price, in practice they rarely seem to find the time to do so. Therefore, by the time the triggering event occurs, the fixed price originally agreed to may no longer be relevant, and may cause significant prejudice to the departing shareholder (or, alternatively, to the purchaser if the future of the business has become bleak).

To the extent that the parties do not have equal negotiating abilities, the price agreed upon and the approach under which the price is determined may not be fair. Thus, the absence of a price-setting mechanism may be better than having one that is outdated.

Finally, it may be costly to maintain this type of mechanism because professional fees will be incurred on an annual or other periodic basis. Nonetheless, allowing this disadvantage to stand in the way may be "penny wise and pound foolish".

Price Determined By an Independent Third Party

There are different ways in which price can be established by a third party, such as a valuator.

Advantages

Determining price/value as of the time that the specified event occurs will provide a current value.

The valuator named to establish price/value must be given full and clear direction as to the principles and methodology to be employed (for example, whether the terminating shareholder's interest is to be discounted if it is a minority holding; whether "special purchaser" considerations are to be included; whether the valuation should recognize the loss of the terminating shareholder's services). This is not to be confused with the so-called formula approach, but rather relates to the basic valuation principles and

definitions. Furthermore, from a practical point of view, a valuator who is requested to determine price/value under the buy-sell clause of a shareholder's agreement should consider whether he or she is acting in the capacity of a quasi-arbitrator and thereby possibly immune from legal liability.

Formula Approach

The most common formulae are based upon either assets or earnings. Sometimes an assets-based formula will include a provision that a fixed, predetermined amount be aggregated with book value to recognize goodwill or other intangibles. In addition, the formula may provide for additional adjustments such as the adding back of certain reserves.

Earnings-based formulae include a capitalization of earnings using, for example, an average of a specified number of years' profits so as to avoid distortions resulting from abnormal years. Often the price/earnings multiple is provided as a *fait accompli*. In certain other cases, a combination of an asset-based approach and an income approach may be used. Some formula approaches are based on a percentage of gross revenues rather than net earnings.

Advantages

The main advantage to the formula approach is that it can usually be calculated easily. Also, to the extent that no outside professionals are retained, it is one of the least costly alternatives.

Disadvantages

The formula approach often proves to be the most unrealistic, particularly as time elapses, if there are no updating mechanisms. In fact, what appears to be the ideal valuation approach at the time of the specified event may not coincide with the formula in the buy-sell clause. While, say, the earnings approach may have been the appropriate basis for determining value at the time the buy-sell clause was drafted, when the specified event occurs the assets approach to valuation may be appropriate (e.g., if the company had since ceased business operations and became an investment holding company). Tax practitioners are cognizant of

the related jurisprudence in this regard.¹²

Even if the company has not changed its nature or its operations, numerous internal and external factors bearing on value are generally not taken into account using a formula. For example, if the formula establishes a certain capitalization (or discount) factor to be used, it may be totally unrealistic, as changes occur with time and circumstances.

A formula approach does not take into account the parties' wish to have different values or different payment terms, depending upon the specified event. For example, when a shareholder is dismissed, the price to be paid and the terms of payment may be different from what they would be had he or she retired from the company.

Price Determined By Shotgun (Put-Call) Arrangement

In practice, the shotgun approach is employed more widely in situations where the parties may be concerned about a possible falling-out between or among them. It can also be used in the event of death. In effect: "**You** cut the pie in two, and **I** will choose my slice!"

Under the shotgun arrangement, a shareholder can make an offer to the other shareholder(s) either to sell or to buy at a price, and upon terms, designated by him. The other shareholder(s) may either accept or decline. If the offeree declines, the offeror has the right to decide whether to buy or to sell. Therefore, if the offeror **asks too high a price** (assuming such offer is to sell), the offeree may respond by requiring the offeror to pay that same price for the offeree's shares. On the other hand, if the offeror **offers too low a price** to the offeree, the offeree may respond by buying out the offeror at that low price. The offeror is thus forced to adopt a fair and reasonable price by naming a price at which they must either buy or sell.

Advantages

If the parties have equal financial backing and are equally informed as to the future prospects of the business, the shotgun approach should establish a fair price, since the offeror will be forced to sell if his/her valuation is too low;

alternatively, he/she will be forced to buy if his valuation is too high. In effect, the offeror must set a fair price since he or she does not know whether either a purchase or sale will result.

Disadvantages

The shotgun approach necessarily assumes that both parties have equal financial strength and equal information about the company and its prospects. It also assumes (though the opposite actually may be the case) that the respective shareholdings are of similar size. However in the case of, say, two shareholders, one owning 85% and the other 15%, it obviously is simpler for the 85% shareholder to buy, since the 15% shareholder may not have the resources to acquire the large holding. A small shareholder may therefore be forced to ask for a price lower than fair market value to avoid being forced into becoming the purchaser.

A variation of the shotgun approach is an auction, or a restricted auction, whereby upon the triggering of the specified event, all of the shareholders are required to put their shares up for auction among themselves. By this route, the parties are assured that they will be able to acquire the other shares, provided that they pay the price. As with the shotgun arrangement, however, a shareholder can be forced out if the offeror is prepared to pay a high price.

Price Determined By Right of First Refusal

Shareholders' agreements generally contain a provision requiring that any shareholder who desires to sell his shares must first offer them to the continuing shareholders. If a bona fide offer has been received from an outside third party, the terminating shareholder must offer her shares to the continuing shareholders on terms and conditions that are no less favorable. If the remaining shareholders do not exercise their right of first refusal, the departing shareholder may sell to the *bona fide* third party after a specified period. In Canada, when there is a unanimous shareholders' agreement, the purchaser will become a party to the original shareholders' agreement and her shares will become subject to the agreement.

CONCLUSION

As can be appreciated from the foregoing commentary, which addresses only some of the possible problems, a business valuator should definitely be consulted during the drafting of the buy-sell agreement, as should an attorney, accountant and life insurance agent. This may avoid many problems when ultimately the specified event triggers the buy-sell provisions of the shareholder agreement.

Endnotes

- (1) Alternatively, the corporation or other named parties can acquire the terminating shareholder's shares.
- (2) In Canada, other types of events might include a shareholder's ceasing to be resident in the country and the company would thereby cease to qualify as a "Canadian-controlled private corporation" for purposes of the favorable "small business deduction under the *Income Tax Act* (Canada).
- (3) Orville B. Lefko, "Buy-Sell Agreements and Appraisals" (February 1976), 55 *Michigan State Bar Journal* 116-26.
- (4) *Terminology for Accountants*, 4th Edition (Toronto: The Canadian Institute of Chartered Accountants, ("CICA") 1993).
- (5) *Ibid.*
- (6) SFAS 142 of the Financial Accounting Standards Board in the U.S., and in Canada, Section 3062 of the *CICA Handbook*.
- (7) See. Richard M. Wise, "The Effect of Special Interest Purchasers on Fair Market Value in Canada", *Business Valuation Review*, Vol. 22, No. 4, December 2003, pp. 196-203.
- (8) James C. Bonbright, *The Valuation of Property*, 2 vols. (New York: McGraw-Hill, 1937), 1058.
- (9) Glossary developed by the American Institute of Certified Public Accountants, American Society of Appraisers, The Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts, and The Institute of Business Appraisers.
- (10) *Brown v. Allied Corrugated Box Co., Inc.* (1979), 154 Cal. Rptr. 170 (Cal. CA).
- (11) *Bexley et al. v. Dunning* (1976), 4 WWR 446 (BCSC).
- (12) For example, in the U.S., IRC, Section 2703 and *Lauder v. Comm'r*, TCM 1992-936 and TCM 1990-530 and in Canada, IT-140R3, "Buy-Sell Agreements".

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