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SETTING THE PRICE IN A CLOSE CORPORATION BUY-SELL AGREEMENT

*David Keith Page**

THE stockholders of a close corporation may consider it important to keep control of the business "within the family." This can be accomplished through a restrictive agreement, typically one which gives the corporation or the remaining stockholders a first option to purchase the shares of any departing stockholder.¹ The original owners may also wish to guarantee themselves a ready purchaser for their stock when they die or leave the business. This second objective can be attained by adopting a restrictive agreement which places an obligation on the departing stockholder to sell to the corporation or to the surviving stockholders, who in turn are obligated to buy from him. Such a mandatory scheme is commonly known as a buy-sell agreement.

Perhaps the most challenging and certainly the most significant decision confronting the draftsman of a buy-sell agreement is the selection of the price or price-fixing technique. From a legal standpoint, the agreement may be void or unenforceable on the ground of vagueness if the price-fixing provision is omitted.² From a practical standpoint the provision is the heart of the contract. It is the device which determines, often at some remote future date, the financial position of the parties vis-à-vis the corporation. Thoughtfully conceived and drafted it can be the mechanism for a mutually satisfactory division of closely held business interests. But when selected without adequate reflection as to its appropriateness in a given situation, it can be the source of confusion, disputes, and often litigation.³

The price-fixing provision must be, in every sense of the word, tailor-made. Because each corporate situation is unique,

* LL.B., Harvard, 1958.—Ed.

¹ For an excellent discussion of all aspects of restrictive agreements, see O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 (1952).

² See *Baumohl v. Goldstein*, 95 N.J. Eq. 597 at 603, 124 A. 118 (1924) (dictum).

³ See Forster, "Valuing a Business Interest for the Purposes of a Purchase and Sale Agreement," 4 STAN. L. REV. 325 at 346 (1952).

no one technique can be said to be superior to all others in every instance.⁴ Nor for that matter can any particular technique be condemned as universally unsatisfactory, although one is hard pressed to find justification for the use of certain methods, such as allowing the board of directors to set the price. However, there are certain considerations which are so fundamental to the intelligent selection of a price-fixing technique that a brief discussion of them here might be useful before proceeding to a more detailed examination of the techniques themselves.

FACTORS TO BE CONSIDERED IN SELECTING A PRICE-FIXING TECHNIQUE

When the stockholders of a small corporation agree to buy each other out after certain events, such as the death or retirement of one of them, is it necessary that the acquisition price be "fair"? Implicit in this question is the assumption that one can define and pinpoint a "fair" price. Presumably it is the price that would be paid by a willing buyer to a willing seller in an arm's-length transaction immediately following the event. Yet the very nature of the typical close corporation makes this definition illusory. Seldom does closely held stock have an ascertainable market value.⁵ There may be no buyers at all for an interest in a personal, family, or highly specialized business. Indeed it is the very prospect of unsaleability which normally gives rise to the buy-sell agreement itself. Nevertheless, there are methods which can be used to approximate the theoretical "market value" of a small business with some degree of objectivity and reliability. Therefore, the real question the draftsman must ask himself is "How essential is it that I select the one price-fixing technique which will reflect most closely 'market value'?"

There is something to be said for a less-than-fair-value purchase of a departing stockholder's interest, sometimes called a "cheap takeover." While actively engaged in the business, a stockholder contributes to its growth and normally withdraws much of his interest in the form of salary. Once the active relationship is

⁴ See ROHRICH, *ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES*, rev. ed., 106 (1953).

⁵ See Kragen, "Some Thoughts on the Valuation of Closely Held Business Interests," 43 CALIF. L. REV. 781 (1955).

terminated by death or retirement, it may not be unreasonable to consider his interest as nominal and to value it accordingly, thereby freeing the business from draining obligations to past members.⁶ This view may be especially attractive where the corporation is a family business; for even a "fair" payment would merely redistribute wealth within the family unit. However, as will be pointed out later, serious tax disadvantages may result from undervaluation in such circumstances. Then, too, if at the date of contracting the parties seem to have an equal chance of survival, there is the psychological factor that each party expects, or at least hopes, that he will be the last to go. Coupled with a natural inclination to gamble, this factor could and probably does have a mutually depressing effect on the price fixed.⁷

Despite the above considerations, it seems preferable in most cases to fix the price as close as possible to the anticipated "fair" value. Not only might this be crucial in determining the valuation for estate and inheritance tax purposes, but it also substantially reduces the likelihood of friction or even litigation between the parties.⁸ Although prevailing law does not seem to regard mere inadequacy of price as sufficient to render restrictive agreements invalid,⁹ there are some decisions to the contrary.¹⁰ By giving each party a "fair" price, the agreement is simply compensating each stockholder for his labor and foresight. The parties are not, therefore, forced during their lifetimes to squeeze the corporation of large sums in the form of salaries or dividends.

Of course it is sometimes necessary to sacrifice complete fairness in order to satisfy other objectives such as ease of application and economy of operation. Any resulting disparity in price can be justified by the fact that each party stands to gain as much as he might lose from the disparity, at least where each party has an

⁶ Ness, "Federal Estate Tax Consequences of Agreements and Options To Purchase Stock on Death," 49 COL. L. REV. 796 at 816 (1949).

⁷ Id. at 815.

⁸ LAIKIN, DEATH, TAXES AND YOUR BUSINESS 22 (1948).

⁹ See, e.g., *Allen v. Biltmore Tissue Corp.*, 2 N.Y. (2d) 534, 141 N.E. (2d) 812 (1957), where the court granted specific performance to an agreement which required the retiring shareholders to take a price equal only to what they had originally paid, although the actual value was considerably higher.

¹⁰ See, e.g., *Greene v. E.H. Rollins & Sons, Inc.*, 22 Del. Ch. 394, 2 A. (2d) 249 (1938), where a provision allowing the corporation to repurchase stock at a price equal to asset value per share, exclusive of good-will or going-concern value, was declared invalid as unfair and against public policy.

equal chance of being a buyer rather than a seller under the agreement.¹¹

In addition to being "fair," the price-fixing mechanism must be framed in such a way as to eliminate or minimize future controversies. Vague or ambiguous terminology is the most frequent cause of litigation over buy-sell agreements.¹² Some techniques, such as using par value or a flat dollar amount as the transfer price, are by nature free from interpretative difficulties. Others, for example basing the price on "book value," can be deceptively simple. Still others, particularly those involving formulae, contain terms which must be precisely defined if the technique is to operate at all.

The buy-sell agreement will offer little protection to some stockholders if the agreement price, though fair when set, can be manipulated by those in control of the corporation. This is the obvious objection to the technique which places the price determination in the hands of the company's board of directors.¹³ More subtle forms of manipulation can be achieved under other price-fixing techniques. For example, where "book value" is to be the guide to valuation, the directors' control of such decisions as the amount to be included in reserves and whether to value assets at cost or current worth may significantly affect the price. Although the directors are probably required by law to act in good faith in these matters,¹⁴ the scope of their permissible conduct remains extremely broad. It is occasionally suggested that a provision be included in the restrictive agreement permitting a stockholder unilaterally to withdraw after a number of years.¹⁵ Although there may be instances in which such a provision would prove useful,¹⁶ it can also lead to a form of manipulation. When the specified period is about to expire, the stockholder whose prospects

¹¹ See O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 at 797 (1952).

¹² The following terms, among others, have created difficulty because of their uncertain meaning: earnings, *Gerding v. Baier*, 143 Md. 520, 122 A. 675 (1923); net cost price, *Cohen v. Elias*, 176 App. Div. 763, 163 N.Y.S. 1051 (1917); net returns, *Jeffrey v. Genter*, (Pa. Com. Pl. 1944) 45 Lack. Jur. 101.

¹³ See *Krebs v. McDonald's Exr.*, (Ky. 1953) 266 S.W. (2d) 87 at 89-90.

¹⁴ See *First Nat. Bank of Montclair v. Coldwell*, 286 App. Div. 1079, 145 N.Y.S. (2d) 674 (1956).

¹⁵ See Kubicek, "What Every Lawyer Should Know About Restrictions on the Transferability of Stock," 43 ILL. B. J. 766 at 776 (1955).

¹⁶ See Overbeck and Teevan, "What Every Lawyer Should Know About Buy and Sell Agreements," 43 ILL. B. J. 264 at 277-278 (1955).

for survival look the best can force his co-stockholder to renegotiate a lower valuation for their interests by threatening to withdraw from the agreement altogether, leaving the co-stockholder with unmarketable stock. There may be other occasions, however, when a provision for complete termination of the agreement would be desirable, as in the event of corporate bankruptcy, receivership, or dissolution or upon the death of a specified number of stockholders.¹⁷

Cost to the client must, of course, be considered in drafting the restrictive agreement. Certain techniques, like "book value" and capitalization of earnings, have pivotal terms which require precise definition. Consequently they will take more of the draftsman's time. Techniques involving appraisal or arbitration may be easier to draft, but the actual use of these methods at the operative date can be quite expensive.¹⁸

In formulating the price-fixing mechanism, the lawyer should not overlook the effect on the value of the corporation of the event which makes the agreement operative. Since most stockholders in close corporations are active in the daily conduct of the business, the death or retirement of any given stockholder might severely impair the corporation's earning capacity. This is particularly true in service businesses, where good will rests on the personalities of a few key men, and it is also true where a stockholder has peculiar talents or information vital to the business. To set the agreement price, by capitalizing earnings for example, without adjusting for the operative event would unjustly burden the survivors and give a windfall to the departing stockholder. Some attorneys provide for the impact of the operative event by specifically excluding any figure for good will from the computation of the purchase price, usually based on "book value."¹⁹ This may jeopardize an otherwise low federal estate tax valuation, and it would be better to assign a nominal value to good will when using "book value," and in other techniques to spell out that good will was considered in making the ultimate formulation.

If one of the parties has a minority interest in the corporation,

¹⁷ Kubicek, "What Every Lawyer Should Know About Restrictions on the Transferability of Stock," 43 ILL. B. J. 766 at 776 (1955).

¹⁸ See ROHRICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES, rev. ed., 112 (1953).

¹⁹ Cf. Block, "Book Value Pitfalls in Buy-Sell Agreements," 95 TRUSTS AND ESTATES 408 (1956).

not only must he protect himself against possible abuse of the price-fixing mechanism by those in control but he must also not permit his weaker bargaining position to force him to accept an undesirable technique.²⁰ A more advantageous approach would be to press for a "fair" method of valuation and then agree to have a certain sum deducted from his share or added to the majority holder's share to allow for the inherent differences in value between controlling and minority interests. A similar provision can be utilized in multi-party buy-sell agreements where one stockholder owns "key" stock.²¹

Whether the parties to the buy-sell agreement are only the stockholders *inter se* or include the corporate entity, it is quite common to provide the cash necessary to purchase departing interests by taking out insurance on the life of each stockholder. The introduction of this insurance feature raises many ticklish problems,²² especially in the area of federal income taxes. This article will not attempt to deal with those problems except insofar as the use of insurance has direct repercussions on fixing a price. Obviously, the closer one is able to predict the ultimate purchase price the better he will be able to choose the proper amount of insurance needed for the funding. On the other hand, there are some cases in which the purchase price will turn in part on the amount of insurance procured. If the corporate entity is a party to the buy-sell agreement, the amount of insurance proceeds received by the corporation on the death of a stockholder becomes an asset of the corporation and ought to be included in the computation of the deceased's interest.²³ Some agreements go so far as to fix the purchase price at "book value" or the amount of the insurance proceeds, whichever is higher.²⁴ Naturally this can give a substantial windfall to the departing stockholder if his interest has been over-insured.

²⁰ See Ness, "Federal Estate Tax Consequences of Agreements and Options To Purchase Stock on Death," 49 COL. L. REV. 796 at 816 (1949).

²¹ Cf. Bushman, "Valuation of Close Corporation Securities," 90 TRUSTS AND ESTATES 228 at 233 (1951).

²² See note, 71 HARV. L. REV. 687 (1958).

²³ For a fuller discussion of the impact of insurance on fixing a price and the possible inequities that can result when the insurance proceeds are omitted from the computation, see Davis, "Recent Developments in Business Purchase Agreements," 94 TRUSTS AND ESTATES 284 (1955).

²⁴ See Overbeck and Teevan, "What Every Lawyer Should Know About Buy and Sell Agreements," 43 ILL. B. J. 264 at 269 (1955).

The selection of the appropriate documents in which to place the agreement itself has some bearing on the price-fixing provision. Broadly speaking, buy-sell provisions are valid whether placed in the articles of incorporation or in a separate stockholders' agreement.²⁵ There is some controversy concerning the validity of placing the buy-sell provisions in the corporate by-laws in the absence of express authorization by the articles to do so.²⁶ The practice has generally been, according to one leading authority, to place the buy-sell provisions in separate stockholders' agreements rather than in either the articles or the by-laws.²⁷ There may be good reason for omitting the buy-sell provisions from the articles, at least in jurisdictions where the appropriate state agency carefully examines all charter provisions and rejects those it considers improper.²⁸ In Illinois, for example, the "Corporation Department of the Office of Secretary of State refuses to accept for filing articles which contain a restrictive provision fixing an unfair price, such as one requiring a shareholder to sell his \$100 par value shares for a flat price of \$50."²⁹ Nevertheless, it would seem preferable whenever possible to put the provisions in both the articles and a separate agreement.³⁰

Regardless whether the provisions are placed in the articles, by-laws, or separate agreement, they should definitely be included on every stock certificate.³¹ The Uniform Stock Transfer Act provides ". . . and there shall be no restriction upon the transfer of shares so represented by virtue of any by-laws of the corporation, or otherwise, unless the right of the corporation to such . . . restriction is stated upon the certificate."³² This statute has sometimes been construed to mean that a mere reference in the stock certificate to the by-laws or other source of the restriction is

²⁵ ROHRlich, *ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES*, rev. ed., 102-103 (1953).

²⁶ See Cataldo, "Stock Transfer Restrictions and the Closed Corporation," 37 VA. L. REV. 229 at 237 (1951).

²⁷ O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 at 782 (1952).

²⁸ *Id.* at 783.

²⁹ Kubicek, "What Every Lawyer Should Know About Restrictions on the Transferability of Stock," 43 ILL. B. J. 766 at 775 (1955).

³⁰ O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 at 786-788 (1952).

³¹ Cataldo, "Stock Transfer Restrictions and the Closed Corporation," 37 VA. L. REV. 229 at 231 (1951).

³² Uniform Stock Transfer Act §15, 6 U.L.A. 20.

insufficient to impose the restriction upon a transferee of the stock, even one who had actual notice of the restrictive provisions.³³ Presumably, if the restrictive provisions were too long to be included in full upon the stock certificate, the statute would be satisfied by a statement on the certificate of the duty of the holder to sell to the corporation or to the other stockholders, mention of the price or price-fixing method, and a reference to the articles, by-laws, or separate agreement where the complete terms might be found.

Naturally the legality of any price-fixing technique must be checked under local law. This is especially true of provisions which set the price by arbitration, for executory agreements to arbitrate are unenforceable in many jurisdictions.³⁴

The most obvious, and often thought to be the most important, consideration is the tax consequences of the buy-sell agreement, particularly the binding effect of the price fixed in the agreement on the estate and inheritance tax valuation of a deceased stockholder's shares. Discussion of this subject will be postponed until after we have considered more closely the individual price-setting techniques.

THE TECHNIQUES OF PRICE-FIXING

Although the variety of price-fixing methods is limited only by the imagination of the draftsman, authorities have noted certain methods which are employed with some regularity.³⁵ Those which

³³ See, e.g., *Hopwood v. Topsham Tel. Co.*, (Vt. 1957) 132 A. (2d) 170; but see *Allen v. Biltmore Tissue Corp.*, 2 N.Y. (2d) 534, 141 N.E. (2d) 812 (1957).

³⁴ At common law, a general agreement to submit to arbitration any and all disputes arising under a contract is voidable at will by either party before a valid award is made. *Home Ins. Co. v. Morse*, 20 Wall. (87 U.S.) 445 (1874). However, the agreement is enforceable if an award is made, and damages may be recovered for its breach. *Red Cross Line v. Atlantic Fruit Co.*, 264 U.S. 109 (1924); 135 A.L.R. 79 (1941). Statutes and an increasing judicial willingness to accept arbitration as a quick and inexpensive way to settle disputes have tended to restrict the rule. *Johnson v. Noble*, 13 N.H. 286 (1842); *Burchell v. Marsh*, 17 How. (58 U.S.) 344 (1854); *Nelson v. Atlantic Coast Line R. Co.*, 157 N.C. 194, 72 S.E. 998 (1911); *Shanferoke Coal & Supply Corp. v. Westchester Service Corp.*, 293 U.S. 449 (1935); *McIntosh v. Hartford Fire Ins. Co.*, 106 Mont. 434, 78 P. (2d) 82 (1938).

³⁵ The common methods of valuation include: flat price, book value, market price, appraisal, arbitration capitalization of earnings, authorization of director or shareholders to establish price, years purchase formula, best offer, tax valuation, or some combination of these. See FINNEY AND MILLER, *PRINCIPLES OF ACCOUNTING: INTRODUCTORY*, 4th ed., 272 (1953); O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 at 801-804 (1952); *New England Trust Co. v. Abbott*, 162 Mass. 148, 38 N.E. 432 (1894).

seem to be the most suitable for the ordinary close corporation are discussed in the sections which follow. The others, in the opinion of this writer, do not merit extensive treatment here because they contain certain objectionable features which make them unacceptable for general use. For example, an attempt to set the price by use of the "market value" of the stock, while desirable in theory, is usually impossible in close corporations, which typically have no ready market for their stock.³⁶ Using the average value of listed stocks in the same industry as a guide to "market value" can be extremely dangerous because it precludes consideration of the unique features of the corporation in question and neglects the influence of the operative contingency on true value.³⁷ Similarly, a price based on the "best offer" received by the stockholder for his shares within a given period is completely unsatisfactory where the stock, under the buy-sell agreement, is subject to mandatory sale to the corporation or other stockholders.³⁸ As a practical matter, no offers for that stock will be made. A price-fixing method which accepts the valuation made for estate or inheritance tax purposes is not desirable because of the delay involved and the loss of possible tax benefits the restriction might otherwise create.³⁹ Also undesirable are methods which use as the purchase price estimated future earnings of the corporation within a given period or installment payments of a percentage of actual future earnings within that period. These methods involve not only the risk and unpredictability of future profits but, at least in the latter case, the probability that the Commissioner will make an independent determination of value which will be higher than the price actually received by the estate. The obvious disadvantage of a method which allows the surviving shareholders or directors to set the price is that it gives "a carte blanche grant of power to . . . set the valuation at whatever they [consider] reasonable so long as they [act] in good faith."⁴⁰ One

³⁶ See O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 at 801 (1952).

³⁷ But see Johnson, Shapiro and O'Meara, "Valuation of Closely-Held Stock for Federal Tax Purposes: Approach to an Objective Method," 100 UNIV. PA. L. REV. 166 (1951), where it is suggested that the value of comparable listed stocks be used to fix a floor-ceiling range on the valuation.

³⁸ See O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 at 802 (1952).

³⁹ *Id.* at 805.

⁴⁰ *Krebs v. McDonald's Exr.*, (Ky. 1953) 266 S.W. (2d) 87 at 90.

major difficulty with the so-called Solomon's choice method in which the survivor makes up two equal lists of assets from which the executor takes his choice⁴¹ is that it forces a termination of the business if the executor chooses the list with most of the working assets.

Book Value

The method which appears to be the "most frequently used starting point" for fixing the price in a buy-sell agreement is book value.⁴² No doubt the reason for this extensive use of book value is its apparent simplicity of operation coupled with reasonably accurate approximation of "fair" value. However, as many lawyers have discovered to their dismay, both the simplicity and accuracy of book value are likely to be illusory.⁴³

What exactly is meant by the term "book value" when used as a measure of price in a buy-sell agreement? This question has been the subject of much litigation and the answers have not been uniform.⁴⁴ The controversy involves whether to have a "strict, literal utilization of book accounts (as reflected in a balance sheet) or whether modifications, other than for blatant errors, may be made to 'correct' or more fairly set forth the book values."⁴⁵ Although the courts tend to lean toward the strict, literal interpretation,⁴⁶ especially when the provision is tied to the accounting practices commonly used by the corporation,⁴⁷ there is no guarantee that they will do so in any particular case. In the recent case of *Aron v. Gillman*,⁴⁸ for example, a New York court was construing a restrictive agreement under which the price was to be set by "book value" as "determined by the most recent audit" of the company. The court held that the value of the inventory should have been based on a physical count rather than on the estimated basis

⁴¹ See Forster, "Valuing a Business Interest for the Purposes of a Purchase and Sale Agreement," 4 STAN. L. REV. 325 at 325 (1952).

⁴² Id. at 327.

⁴³ See O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 at 799 (1952).

⁴⁴ See comment, 31 N.Y. UNIV. L. REV. 608 at 611 (1956). Compare Stans and Goedert, "What Is Book Value?" 99 J. ACCOUNTANCY 38 (Jan. 1955) with May and Dohr, "Book Value: A Brief Comment on the Stans-Goedert Article," id. at 42 (April 1955).

⁴⁵ Block, "Book Value Pitfalls in Buy-Sell Agreements," 95 TRUSTS AND ESTATES 408 (1956).

⁴⁶ Ibid.

⁴⁷ See, e.g., *Soechtig v. Amick*, 285 App. Div. 701, 140 N.Y.S. (2d) 85 (1955).

⁴⁸ 309 N.Y. 157, 128 N.E. (2d) 284 (1955).

actually used in the "most recent audit." Moreover, an item for accrued income taxes, which had not been reflected on the company's balance sheet, was required to be considered in the determination of "book value." This case, and others like it, demonstrates that the attorney who drafts a buy-sell agreement calling for the purchase of the stock at "book value" without further definition may be subjecting his client to costly litigation.⁴⁹ It is absolutely essential that the agreement spell out exactly what is meant by "book value," who is to make the determination of disputed items, and the conclusiveness of that determination. The inclusion of some vague phrase limiting "book value" in accordance with "generally accepted accounting practices" or "recognized accounting principles" is of less than no help since it invites a dispute as to what practices and principles are so accepted and recognized. One way of minimizing the possibility of future disputes over the meaning of "book value" is to provide that the net worth (assets minus liabilities) which appears on the balance sheet for the last fiscal period shall be conclusively deemed to equal the aggregate book value of all stock in the corporation.⁵⁰ The difficulty with this method is that, though reducing definitional problems, it may result in a figure which is not fair to either the buyer or the seller in terms of the actual underlying values of the corporation's assets. Moreover, it is especially disadvantageous to a minority stockholder since it carries the seeds of potential manipulation of balance sheet figures by the directors who, as long as they act in good faith, are under no obligation to reflect the actual value of the assets on the corporation's books.⁵¹ Thus the minority may find themselves at the mercy of the majority as was true in *Druchlieb v. Harris*⁵² where the court sustained a write-down of good will and other assets by the directors in the face of a restrictive agreement calling for a purchase price based on "book value."

⁴⁹ Compare *Hollister v. Fredler*, 22 N.J. Super. 439, 92 A. (2d) 52 (1952), with *Fleming v. Fleming*, 211 Iowa 1251, 230 N.W. 359 (1931), and *Elhard v. Rott*, 36 N.D. 211, 162 N.W. 302 (1917). See comment, 24 UNIV. CIN. L. REV. 592 (1955).

⁵⁰ See *Rubel v. Rubel*, 721 Miss. 848, 75 S. (2d) 59 (1954); *Lane v. Barnard*, 185 App. Div. 754, 173 N.Y.S. 714 (1919); *Gurley v. Woodbury*, 177 N.C. 70, 97 S.E. 754 (1919). But cf. *Wineinger v. Kay*, (Tex. Civ. App. 1933) 58 S.W. (2d) 876; *Mills v. Rich*, 249 Mich. 489, 229 N.W. 462 (1930). See comment, 53 MICH. L. REV. 972 at 987 (1955). Cf. *Overbeck and Teevan*, "What Every Lawyer Should Know About Buy and Sell Agreements," 43 ILL. B.J. 264 at 269-270 (1955).

⁵¹ See, e.g., *Corbett v. McClintock-Marshall Corp.*, 17 Del. Ch. 165, 151 A. 218 (1930).

⁵² 209 N.Y. 211, 102 N.E. 599 (1913).

Manipulation can be avoided if it is provided that "book value" is to be determined not by the corporation's books alone but by an outside accountant who may use the books as a reference but who is not necessarily bound by them and whose decision shall be conclusive and binding on the parties.⁵³ Here again there is a temptation to insert some standard, such as "limited only by recognized accounting principles," to guide the accountant, but it is the opinion of this writer that the temptation should be resisted. Such a standard will add little if anything to the actual criteria which the accountant will use in reaching his decision, but it opens the door to assertions by disappointed parties that the accountant has acted beyond his discretion. On balance, it would seem preferable to choose the disinterested accountant with great care and then rely upon his integrity and ability to insure a fair and impartial decision. This method will be more expensive than mere reliance on the corporate books, but the reduction of the chances of disputes and litigation should justify the additional expense in most instances. It will be noted, of course, that this method embodies an approach similar to that found in the appraisal and arbitration methods. However, it is tied to the general concept of "book value" which may be attractive to the parties, and yet it minimizes some of the risks inherent in that concept.

A more fundamental objection directed toward the use of "book value," regardless of who applies that concept, is that it is an unreliable guide to the measurement of actual values.⁵⁴ It is commonly a record of historical costs and rarely reflects the current values of the corporation's assets. The amounts which appear in the depreciation reserves represent an amortization of original cost rather than an accurate picture of the wear and tear on the assets. Intangibles, like good will, are seldom shown on the balance sheet or are carried at nominal figures, although they often comprise a large part of the real value of a small business. Inventory is usually carried at "lower of cost or market" which, when used in the computation of "book value," gives an obvious advantage to the purchaser under the buy-sell agreement.⁵⁵ In short, a book value approach normally gives an asset-by-asset compil-

⁵³ See LAIKIN, *DEATH, TAXES AND YOUR BUSINESS* 24 (1948).

⁵⁴ See O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 *HARV. L. REV.* 773 at 799 (1952).

⁵⁵ See ROHRlich, *ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES*, rev. ed., 109 (1953).

ation of cost (even neglecting some assets) rather than a going-concern valuation.

This may not be undesirable in all cases. Good will may disappear with the disappearance of a key stockholder. Book values may otherwise approximate actual values. All the parties may be willing to gamble on whatever discrepancies remain. "There is some suspicion that book value is occasionally prescribed as the valuation basis, though substantial intangible values exist, because of the fear of the complexity and cost of evaluating intangibles, and the probability of litigation."⁵⁶

The crucial point to be recognized here is that whether the parties want an accurate reflection of true values or whether they are willing to allow considerable leeway, they must spell out their intentions precisely. The mere use of the term "book value" will not assure either result.⁵⁷ If the agreement refers to "book value," it should specify whether this means as shown on the books used for corporate or for tax purposes.⁵⁸ All elements which might create disputes should be carefully delineated as to their inclusion or exclusion from "book value," and the exact bases of inclusion should be described. A partial list of items that should be dealt with includes recognition of appreciation or diminution in the value of assets, method of depreciation, method of inventory valuation, treatment of reserves for contingencies, recognition of good will and other intangibles, method of computing bad debt reserves, and capitalization of repairs and improvements. "In any event, unless the agreement calls for the separate valuation of goodwill, it should expressly provide that the amount to be paid for the decedent's interests *includes* payment for goodwill. Disputes and litigation between the parties and with the tax authorities may result if this is overlooked."⁵⁹ The lawyer should work with the company's accountant and receive his approval of the various

⁵⁶ Block, "Book Value Pitfalls in Buy-Sell Agreements," 95 TRUSTS AND ESTATES 408 at 408 (1956).

⁵⁷ Compare *Aron v. Gillman*, 309 N.Y. 157, 128 N.E. (2d) 284 (1955), with *Druchlieb v. Harris*, 209 N.Y. 211, 102 N.E. 599 (1913).

⁵⁸ Forster, "Valuing a Business Interest for the Purposes of a Purchase and Sale Agreement," 4 STAN. L. REV. 325 at 328 (1952).

⁵⁹ LAIKIN, DEATH, TAXES AND YOUR BUSINESS 24-25 (1948); Forster, "Valuing a Business Interest for the Purposes of a Purchase and Sale Agreement," 4 STAN. L. REV. 325 at 330 (1952); *Estate of George Marshall Trammell*, 18 T.C. 662 (1952), acq., 1953-1 CUM. BUL. 6; Rev. Rul. 157, 1953-2 CUM. BUL. 255; Proposed Regs. under 1954 Code §20.2031-3, 21 FED. REG. 7867 (1956).

definitions embodied in the agreement. Then the parties should be jointly consulted and the consequences of the definitions should be fully explained.⁶⁰ There are, of course, limitations in terms of the time and money that can be expended on the drafting of such provisions, but, within reasonable bounds and after consultation with the accountants, the attorney should be able to draft a fairly comprehensive provision which will eliminate major future disputes.

Providing elaborate definitions of the components of "book value" is not as essential where the determination is left to a disinterested third party. If the third party was trusted sufficiently to be made the arbiter of the "book value" issue, he can probably be depended upon to take into account the intent of the parties, though not being hamstrung by a legal obligation to do so.

Care should also be taken to provide for the precise date on which the "book value" is to be determined. It might be the end of a specified accounting period, the date notice of the desire to sell is given, the date of death, or the date the survivors give notice of their intent to purchase. "Ordinarily, in order to avoid closing books, making an audit and taking an inventory, it is preferable to provide that book value will be calculated as of the end of the last preceding fiscal or calendar year or some other designated accounting period."⁶¹ Provisions may also be made for appropriate adjustments for the period between the above date and the date of death or payment.⁶² Perhaps some requirement for periodic review of the book value clause by the parties might also be included.⁶³

A buy-sell agreement which uses "book value" as its price-fixing mechanism is widely regarded as a valid agreement, neither confiscatory, a restraint on alienation, nor against public policy.⁶⁴ The desirability of using this method is open to greater doubt.⁶⁵

⁶⁰ Forster, "Valuing a Business Interest for Purposes of a Purchase and Sale Agreement," 4 STAN. L. REV. 325 at 328 (1952).

⁶¹ O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 at 800 (1952).

⁶² See Forster, "Valuing a Business Interest for the Purposes of a Purchase and Sale Agreement," 4 STAN. L. REV. 325 at 329 (1952).

⁶³ Block, "Book Value Pitfalls in Buy-Sell Agreements," 95 TRUSTS AND ESTATES 408 (1956).

⁶⁴ See, e.g., *Coleman v. Kettering*, (Tex. Civ. App. 1956) 289 S.W. (2d) 953; but see *Security Life & Accident Ins. Co. v. Carlovitz*, (Ala. 1949) 38 S. (2d) 274.

⁶⁵ See Kubicek, "What Every Lawyer Should Know About Restrictions on the Transferability of Stock," 43 ILL. B. J. 766 at 774 (1955).

It is not as flexible as a formula or renegotiated fixed-price method, but it might be made so with periodic review. Its accuracy as a measure of value will generally depend on the nature of the business, the accounting practices of the corporation, and the modifications made in those practices under the agreement. Unless terms are meticulously defined or a third party's definition is made conclusively binding, use of "book value" is apt to provoke controversy at the operative date.

Capitalization of Earnings and Other Formulae

The technique of capitalizing earnings has been used with some success in other contexts to arrive at the going-concern value of any given enterprise.⁶⁶ Stated simply, it involves the multiplication of the average annual net earnings of the business by some fixed figure known as the rate of capitalization. Other formula methods, including the two-step technique of A.R.M. 34,⁶⁷ are variations and refinements of the basic capitalization of earnings approach. Most authorities agree that a formula method of valuation is not generally satisfactory for use as the price-fixing mechanism in a buy-sell agreement,⁶⁸ but there are some dissents from this conclusion.⁶⁹ Although criticism is usually levelled at the "complicated calculations" involved in a formula method,⁷⁰ this is not really an accurate appraisal of the problem. The actual computation of a price under a formula is a relatively simple, mechanical matter. If the rates of capitalization which are used as multipliers are specified in the agreement, the only unknown quantity remaining at the time of computation is the "average net earnings" or similar base figure. Once this latter figure is determined (a task which need not be difficult), the steps remaining to

⁶⁶ See ROHRlich, *ORGANIZING CORPORATE BUSINESS ENTERPRISES*, rev. ed., 109 (1953).

⁶⁷ 2 CUM. BUL. 31 (1920). This involves a determination of the earning power of the tangible and intangible assets of a business through a capitalization of these items at different rates. See also Gardner, "The SEC and Valuation Under Chapter X," 91 UNIV. PA. L. REV. 440 (1943).

⁶⁸ See, e.g., Kubicek, "What Every Lawyer Should Know About Restrictions on the Transferability of Stock," 43 ILL. B. J. 766 at 775 (1955); ROHRlich, *ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES*, rev. ed., 109-110 (1953).

⁶⁹ See, e.g., Swados, "Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement," 26 FORDHAM L. REV. 189 at 193 (1957).

⁷⁰ See Kubicek, "What Every Lawyer Should Know About Restrictions on the Transferability of Stock," 43 ILL. B. J. 766 at 775 (1955).

arrive at the ultimate price are merely matters of simple arithmetic.

The real difficulty with formula methods when used in ordinary close corporation buy-sell agreements is one of fairness. The elements of the formula are not usually reliable guides to a true valuation of the business. Perhaps the most unreliable element is the rate of capitalization itself. The draftsman is forced to decide what exact multiple of earnings would accurately reflect the true value of the business. He might be able to use the price-earnings ratio of stock in a comparable business which has a readily ascertainable market value.⁷¹ But finding a comparable business will be hard and there is no assurance that the comparability will persist until the time the formula is to be employed. Or he might adopt a figure that seems appropriate in view of the nature of the business. Although most experts will not hazard a guess as to the "correct" rate of capitalization for businesses in general,⁷² Dewing has classified businesses into certain categories and assigned rates of capitalization to each category.⁷³ He suggests a multiple of four for small businesses of a rank and file character, but even this figure must be reduced for new or personal businesses or those seasonal in nature.⁷⁴ Although his estimates are based upon experience and, to some extent, judicial opinions, there is no assurance that they will be accurate in any given case. This is especially true where the corporation is small and its fortunes subject to wide fluctuations. Any figure selected by the draftsman, though based on sound judgment and authority, will be no more than an intelligent guess. Moreover, the passage of time may cause the guess made on the agreement date to be entirely inappropriate to the character of the business as it exists at the operative date.

Then, too, the fair period over which earnings are to be averaged must be designated. If predicted incorrectly, this decision could lead to a serious distortion of the value of the business. The period ought to be long enough to allow temporary fluctuations to be discounted and short enough to reflect adequately the current earnings picture of the company. Consideration should be given to whether there should be adjustments made for special

⁷¹ See BADGER, VALUATION OF INDUSTRIAL SECURITIES 119 (1925).

⁷² See, e.g., 1 BONBRIGHT, VALUATION OF PROPERTY 259-266 (1937).

⁷³ 1 DEWING, THE FINANCIAL POLICY OF CORPORATIONS 390-391 (1953).

⁷⁴ *Id.* at 389-390.

circumstances, such as war or recessions, during the designated period.⁷⁵

The other key element in the formula is the "annual net earnings." Unless this figure is truly representative of the current earnings status of the company and also sufficiently typical to be the basis for the prediction of future earnings, the ultimate price arrived at under the formula will not be a "fair" approximation of going-concern value. Here again the fact that the operative contingency, such as death of a major stockholder, may severely impair the earning potential of the business has to be reckoned with. If no adjustment is made for that fact, the value based on current earnings will be unrealistically high.

The annual net earnings which appear on the income statement of the ordinary close corporation do not represent the real earning power of the business and to use that figure, without modification, would result in an inequitable price. For in most close corporations a substantial part of the realized income is withdrawn in the form of high salaries, which are recorded in the income statement as an expense which reduces net earnings. Therefore it is essential to provide for some adjustment in the net earnings figure as it appears on the books, unless it is felt that some other factor, such as the loss of the departing shareholder, counterbalances the omission of these salaries. However, one writer warns that the designation of salaries above a specified amount as profits for capitalization of earnings purposes might be inviting tax grief since it puts a red flag on the unreasonableness of these salaries as corporate business expenses.⁷⁶ A further distortion of actual earnings may exist because of abnormally high interest payments being made to stockholders or their families, and attempts to correct this distortion in the price-fixing formula might have similar tax repercussions. Non-recurring items of income and expense, unusual business conditions, and foreseeable changes can also undermine the representative character of the reported net earnings and should be provided for if the formula is to work fairly.⁷⁷ In the formative years of a business operation, earnings, if any, are apt to be very small; yet this may not be indicative of the poten-

⁷⁵ ROHRlich, *ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES*, rev. ed., 110 (1953).

⁷⁶ O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 *HARV. L. REV.* 773 at 803, n. 111 (1952).

⁷⁷ *Id.* at 802.

tial growth of the enterprise, which may prosper once it has taken roots. To capitalize earnings upon the basis of these early figures would not do justice to a departing shareholder whose efforts helped create that eventual prosperity.

The person or method for determining "average annual net earnings," or both, should be fully described in the buy-sell agreement.⁷⁸ Here again the draftsman must decide how many standards he wants to spell out and how much he wants to leave to the judgment of the arbiter, whose decision should be binding.

Use of a capitalization of earnings formula in a buy-sell agreement appears to be needlessly cumbersome in most cases. Where the corporation is relatively small or unestablished, earnings figures and capitalization rates are poor indicia of true enterprise value.⁷⁹ A provision for periodic review of the formula clause, with the old formula to apply if no agreement is reached, might help to keep the formula current but seems, on the whole, insufficient to justify the use of a formula in the ordinary close corporation. The extensive use of accounting terminology in formula techniques tends to stimulate disputes, although much of this can be avoided by careful drafting. In larger close corporations, where the amounts involved are substantial, where the book net earnings are apt to be a fair reflection of the company's position, and where capitalization rates have been tested and verified, a formula may be the best device for determining value and the extra cost and difficulty of drafting may be justified.

Appraisal or Arbitration

Another device, which is often employed in conjunction with one of the other methods but which can be used as an independent method of price-fixing, is the utilization of third parties—appraisers or arbitrators—to set the price under the agreement when it becomes operative. The basic difference between appraisal and arbitration is that the former entails the submission of the price decision to the third party as an initial matter whereas the latter calls upon the third party to decide only if and when the parties themselves have failed to agree on a suitable transfer price.⁸⁰

⁷⁸ ROHRICH, *ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES*, rev. ed., 110 (1953).

⁷⁹ *Ibid.*

⁸⁰ See *Matter of Fletcher*, 237 N.Y. 440 at 445, 143 N.E. 248 (1924).

The term "appraisal" usually suggests a technique by which the underlying assets of a business entity are evaluated. To the extent this connotation is correct, appraisal would not seem well-suited for price determination under a buy-sell agreement, at least where a "fair" price is desired and the business is worth more than the sum total of its component assets. It is perfectly possible, however, to have the third party or parties, whether they be professional appraisers or not, value the business on some basis other than mere asset value. If it is desired that "book value" or "capitalization of earnings" be used as a guide to the appraisal, such a standard can be designated in the agreement.⁸¹ The danger of restricting a third party by some ambiguous standard has already been mentioned, and perhaps it might be wiser to specify that the appraisal need not be confined to the asset value of the corporation but *may* (not *must*) take into consideration any other factors deemed significant by the appraiser, including book value, net earnings, and market prices of similar stocks.⁸²

There seems to be little doubt that provisions leaving the determination of price in a buy-sell agreement to the appraisal of third parties are valid.⁸³ The agreement should include the names of the appraisers or the method by which they are to be selected, who is to pay them and how, and a provision for substitution of new appraisers if the designated ones should be unwilling or unable to serve. The usual method of selection is for each party to choose one appraiser at the time the specified event takes place and have those two appraisers select a third.⁸⁴ This should include a provision explaining how the third appraiser is to be chosen in case of deadlock and requiring that the decision of any two of the three be binding on the parties.⁸⁵ Other methods of selection include designating certain named parties, perhaps the

⁸¹ See O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 at 804 (1952).

⁸² But see Forster, "Valuing a Business Interest for the Purposes of a Purchase and Sale Agreement," 4 STAN. L. REV. 325 at 333 (1952), who insists on giving the appraiser specific standards to do the job.

⁸³ See cases cited in Annotation: Provision of articles, by-laws, or agreement regarding future determination by parties other than owner of price at which corporate stock is to be taken over by corporation or stockholders upon specified event, 117 A.L.R. 1359 (1938).

⁸⁴ See, e.g., provision in *Good Fellows Associates v. Silverman*, 283 Mass. 173 at 178, 186 N.E. 48 (1933).

⁸⁵ Cf. Currie, "Buy and Sell Agreements With Respect to Corporate and Partnership Interests," 1950 WIS. L. REV. 12 at 18.

company's regular accountant, at the time the agreement is drafted.⁸⁶ The major drawback of the use of appraisal as the sole method for price determination is its expense.⁸⁷ Where a substantial sum is involved, however, and there are prospects of future disagreements if such other methods as book value or capitalization of earnings are used, the expense might be worthwhile.

The use of "arbitration" has the advantage of first allowing the parties to try to fix their own price. As a practical matter, the chances of the parties agreeing at the operative date seem slim, although this may not be true where there is a sympathetic relationship between the survivors and the departing shareholder or his heirs. Also, the threat of arbitration hanging over the heads of the parties will tend to curb their more arbitrary tendencies. The considerations involved in guiding arbitrators by standards and the methods of selecting arbitrators are basically the same as those discussed under appraisal. A more serious problem that may be encountered as to arbitration is its legality. In some states an executory contract to arbitrate is unenforceable.⁸⁸ There is also some disagreement as to whether the fixing of a price is an arbitrable issue.⁸⁹ The possibility that a price fixed by appraisal or arbitration will not be binding on the Commissioner for federal estate tax purposes will be considered in the subsequent section on tax problems.

Fixed Price

Another widely adopted method is the use of a specified figure, either a fixed dollar amount or par value, as the take-over price under the agreement. Such a price may be satisfactory for a short period of time,⁹⁰ but it will eventually fall out of line with the true value of the corporation's stock. Although this discrepancy in value will not normally invalidate the agreement,⁹¹ a few courts

⁸⁶ See Forster, "Valuing a Business Interest for the Purposes of a Purchase and Sale Agreement," 4 STAN. L. REV. 325 at 333 (1952).

⁸⁷ See ROHRICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES, rev. ed., 112 (1953).

⁸⁸ See note 34 *supra*.

⁸⁹ See court's discussion of this question in *In re Marshall*, 147 Misc. 4, 262 N.Y.S. 191 (1930).

⁹⁰ O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 at 801 (1952).

⁹¹ Compare *Kaufmann v. Kaufmann*, 222 Pa. 58, 70 A. 956 (1908), with *Sands v. Miner*, 16 App. Div. 347, 44 N.Y.S. 894 (1897).

consider such agreements unconscionable⁹² and some state agencies will refuse to accept articles of incorporation containing such provisions.⁹³ Regardless of the legality of the technique, it seems highly undesirable where the parties have any wish to obtain a "fair" price for their interests.

By the addition of a provision for periodic redetermination of the price by the parties, however, the above unfairness can be largely obviated and the fixed-price method can become one of the most effective devices for setting the price under a buy-sell agreement.⁹⁴ "A typical clause would provide for a yearly review of the price on the same day as the annual meeting of the shareholders and, further, that the new price, if any, should not become effective until reduced to writing and signed by all the parties. . . ."⁹⁵ The advantages of this method are numerous. It is easy to draft, to understand, and to apply. It does not involve any confusing formulae and it is entirely free from specific standards and basic terms which might later generate disputes.⁹⁶ It enables the parties to judge their status at a glance and to adjust their activities accordingly. It does not force the parties to determine the value of the enterprise in any particular manner but rather permits them to hammer out a valuation which seems fair in the light of all factors known to them, including the effect of a stockholder's withdrawal from the corporation. Moreover, it is an extremely flexible method which is able to adjust annually to the changing fortunes of the business. Most significantly, it operates on the self-interest of all the parties to the agreement and is therefore calculated to insure the achievement of a "fair" price, so long as their bargaining positions and chances of survival remain equal. As Forster concludes in his article on valuation, "as of any given time, the owners of a business are the persons best able to determine what it is worth."⁹⁷ In

⁹² See, e.g., *Greene v. E. H. Rollins & Sons, Inc.*, 22 Del. Ch. 394, 2 A. (2d) 249 (1938).

⁹³ See O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 at 783-784 (1952).

⁹⁴ See Kubicek, "What Every Lawyer Should Know About Restrictions on the Transferability of Stock," 43 ILL. B. J. 766 at 775 (1955).

⁹⁵ Overbeck and Teevan, "What Every Lawyer Should Know About Buy and Sell Agreements," 43 ILL. B.J. 264 at 277 (1955).

⁹⁶ But see Rohrlrich, "Legal Problems in the Organization and Structure of a Close Business Corporation," 124 N.Y. L.J. 282, col. 2 (1950), for a quare whether a procedure which requires periodic agreement among the parties doesn't tend to keep alive a point of issue, with the danger of bringing disagreement rather than agreement to the surface.

⁹⁷ Forster, "Valuing a Business Interest for the Purposes of a Purchase and Sale Agreement," 4 STAN. L. REV. 325 at 331 (1952).

view of the fact that interests in close corporations are not usually readily saleable and do not have any clear market values, it has been argued that the value arrived at by arm's-length agreement of the parties is "probably as fair as any."⁹⁸ And, as long as it operates smoothly, it is very inexpensive.

It should be evident that the most serious shortcoming of the periodically-renegotiated fixed-price method as formulated thus far is its susceptibility to abuse by a shareholder who expects to be a survivor. By holding out for a low valuation or refusing to agree and thereby perpetuating the existing low price, he can force a cheap takeover.⁹⁹ There is also the problem of the parties' indolence or neglect which may cause an old price to continue in existence long after it has ceased adequately to reflect "fair" value. One writer has suggested that a remedy for these problems might lie in a "safety clause" providing that the fixed price should not be binding on the parties unless it had been reviewed and approved within, say, two years. And, in the event the old fixed price lapsed, some alternative should be prescribed, such as keeping the old price as a base but automatically adjusting it by the increase or decrease in "book value" between the date of its adoption and the operative date of the agreement.¹⁰⁰ The trouble with this suggestion is that it gives the prospective survivor two years in which to take advantage of the old value and also introduces all the problems inherent in a "book value" technique at the end of those two years. A preferable solution would seem to be a clause which requires the use of appraisal or arbitration to fix the price whenever the shareholders cannot agree or whenever there has been no review of the old price within thirty or sixty days of the date specified for renegotiation.¹⁰¹ The self-interest of the parties and intelligent supervision of their interests by their counsel and accountants should prevent a perpetuation of an old price through

⁹⁸ LAIKIN, *DEATH, TAXES AND YOUR BUSINESS* 27 (1948); but see *Krebs v. McDonald's Exr.*, (Ky. 1953) 266 S.W. (2d) 87 at 90, where the court commented on the fact that the valuations arrived at periodically under the fixed-price agreement never sensitively reflected the changes in actual value throughout the years.

⁹⁹ But see *Chase Nat. Bank v. Manufacturers Trust Co.*, 265 App. Div. 406, 39 N.Y.S. (2d) 370 (1943), where the court undertook to set a fair price when one stockholder refused to agree because of the bad health of the other stockholder.

¹⁰⁰ See Block, "Book Value Pitfalls in Buy-Sell Agreements," 95 *TRUSTS AND ESTATES* 408 (1956).

¹⁰¹ See O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 *HARV. L. REV.* 773 at 806 (1952).

neglect. The draftsman might also want to specify that the appraiser or arbitrator take as his basis for valuation the price last agreed upon by the parties and modify that price only to the extent that the shares have changed their value since the last setting of that price.¹⁰²

One problem that inheres in the fixed-price method, even with periodic redetermination, is the failure of the agreed price to reflect drastic changes that may have occurred in the business between the date of the last agreed price and the operative date of the agreement. These changes might result from such things as dividend payments or other withdrawals, extraordinary profits or losses, assessment of heavy taxes, and the like. One way of minimizing the risk of such occurrences is to increase the frequency of the required redeterminations. However, the increased accuracy of reflected value must be weighed against the additional inconvenience to the parties. It does not seem too burdensome, however, to require the redetermination to be made once every six months, especially if the corporation has a semi-annual audit which allows the parties to evaluate quickly the change in the corporation's financial position. It would also be possible to provide for the parties to make some adjustment in the price for designated extraordinary events, based perhaps on actual or anticipated changes in the next balance sheet. But this might invite controversy as to the proper adjustments. Perhaps the best solution is to combine closely spaced periods of renegotiation with a provision for a responsible third party's adjustment of the last price for extraordinary events since it was set, his decision to be binding. Or the draftsman may conclude that the chances of anything drastic happening from one period to the next are so slight that all parties ought to take the risk since, at the time of drafting, the discrepancy has as much chance of working in favor of each party as against him.

As was the case with a book value method, the agreement should specify that all factors, including good will and other intangibles, were taken into consideration in arriving at the initial price. It would probably be better to omit any requirement that a particular factor be considered by the parties in their later determinations, since this subjects later fixed prices to possible attack for alleged failure to take such a factor into account.

¹⁰² Ibid.

It is this writer's opinion that, as a general proposition, the fixed-price technique, periodically renegotiated with the above modifications, provides the most satisfactory method for arriving at a "fair" price simply and inexpensively.

Combination of Methods

There are innumerable combinations of the basic methods which can be used effectively. Adding appraisal or arbitration to the fixed-price method can, as illustrated above, be helpful in many instances. The draftsman of a buy-sell agreement for a new business might consider the possibility of employing a par value or book value method during the formative years of the enterprise and switching to a formula technique after a predetermined number of years or the achievement of a certain amount of net earnings or both. Suggestions have been made for the use of different valuation techniques to determine the value of different assets, such as appraisal for land and buildings, book value for inventory and fixtures, mutual agreement for patents and trademarks, and capitalization of earnings for good will.¹⁰³ Or one technique can be used to limit another technique, for example, providing that the appraisal value shall not be less than "book value."¹⁰⁴ Then there is the possibility of averaging the results arrived at under two or more different methods.¹⁰⁵

Another variation that merits consideration is a provision which varies the price or the price-fixing method with the nature of the transfer.¹⁰⁶ The agreement might provide that if the corporation or surviving shareholders become obligated to buy the stock of the departing stockholder because of death, disability, or retirement after a certain age (say sixty-five), the purchase price will be 100 percent of the amount determined under the valuation method in the agreement; but if the transfer is for any other reason, such as an early voluntary withdrawal or dismissal for cause, the purchase price will be a lesser percentage, say 80 or 90 percent, of that valuation. This variation may discourage a

¹⁰³ ROHRlich, *ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES*, rev. ed., 113 (1953).

¹⁰⁴ See O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 *HARV. L. REV.* 773 at 806 (1952).

¹⁰⁵ *Ibid.*

¹⁰⁶ *Id.* at 807.

shareholder from voluntarily withdrawing from the corporation when the agreed price looks high or the business prospects look low.¹⁰⁷ Moreover, it will be useful in reducing the financial impact of an unexpected withdrawal which cannot be protected against by funding with insurance as can death and, perhaps, disability or retirement after a fixed date. Whether this difference in price for some inter vivos transfers as compared with the price at death will have any adverse tax consequences is considered in the following section.

TAX CONSIDERATIONS

There are significant tax consequences which attach to the adoption and use of a restrictive agreement, and the draftsman must consider them very carefully in selecting the appropriate form for the agreement. Tax factors may affect or control, among other things, whether the agreement should be a cross-purchase type (among the stockholders exclusively) or an entity type (with the corporation as the redeeming party), and whether the agreement should be funded by insurance. Indeed, one writer has suggested that the obsession with taxes often obscures the more fundamental business and estate planning objectives of restrictive agreements.¹⁰⁸ The need for balanced planning cannot be denied, but it is undoubtedly true that tax considerations weigh heavily in the balance. It is not within the scope of this article to deal with the tax consequences of restrictive agreements as such. A number of good articles have been written on the subject.¹⁰⁹ However, insofar as taxes have a bearing on the choice of a price-fixing mechanism, they have a particular relevance here. Their impact is most noticeable in the area of estate and inheritance valuation of closely held stock; for, with proper planning, the price fixed under the restrictive agreement can be conclusive of value for federal estate tax purposes and, sometimes, for state inheritance tax purposes.¹¹⁰ The agreed price does not,

¹⁰⁷ *Ibid.*

¹⁰⁸ See Swados, "Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement," 26 *FORDHAM L. REV.* 189 at 216 (1957).

¹⁰⁹ See, e.g., Friedman, "Buy and Sell Agreements: A Review and a New Look," *N.Y. UNIV. 15TH INST. ON FED. TAX.* 1053 (1957); comment, 57 *MICH. L. REV.* 578 (1959); note, 71 *HARV. L. REV.* 687 (1958).

¹¹⁰ See *Matter of Miller's Estate*, 191 *Misc.* 784, 79 *N.Y.S.* (2d) 372 (1948). But see *In re Cowles*, 36 *Wash.* (2d) 710, 219 *P.* (2d) 964 (1950). See also note, 71 *HARV. L. REV.* 687 at 691 (1958).

however, fix the valuation of the stock for federal gift tax purposes.¹¹¹ The advantages of having the restricted price establish the value of the stock for estate tax purposes are substantial. It permits more intelligent estate planning by providing a measure of the future estate tax to be assessed and it precludes a long and costly battle with the Internal Revenue Service over the proper valuation.¹¹² More important, however, is the protection it offers against the estate's being burdened with heavy taxes based upon a high valuation for stock which is actually sold at a lower figure.¹¹³ The significance of this last advantage should not be overlooked. Where the Commissioner is not bound by the price in the restrictive agreement, his own valuation is presumed to be correct by the courts.¹¹⁴ And the executor's chances of sustaining a figure even reasonably close to his own valuation are not good.¹¹⁵ The estate tax considerations are important even in corporations whose shareholders have estates small enough to qualify for exemption from federal estate taxes. The restrictive agreement is a long-term arrangement and the fortunes of the corporation or its constituent shareholders may be greatly changed when a death finally makes the agreement operative.

There is some confusion as to exactly what effect a restrictive agreement can have on federal estate tax valuation of the closely held stock. Although the Commissioner officially contends that he need not be bound by a price incorporated within a restrictive agreement regardless of the circumstances,¹¹⁶ the courts have limited the estate tax valuation to the restricted price, despite the Commissioner's objection, where certain essential elements were present.¹¹⁷ Briefly stated, those elements are (1) the agreement must restrict the right of the stockholder to transfer his stock

¹¹¹ See Rev. Rul. 189, 1953-2 CUM. BUL. 294; *Commissioner v. McCann*, (2d Cir. 1944) 146 F. (2d) 385.

¹¹² See Friedman, "Buy and Sell Agreements: A Review and a New Look," N.Y. UNIV. 15TH INST. ON FED. TAX. 1053 at 1068 (1957).

¹¹³ See Koch, "Estate Planning and Tax Aspects of the Buy and Sell Agreement," 5 J. AM. SOC. OF CHARTERED LIFE UNDERWRITERS 65 at 75 (1949).

¹¹⁴ See Rice, "The Valuation of Close Held Stocks: A Lottery in Federal Taxation," 98 UNIV. PA. L. REV. 367 at 378 (1950), and cases cited therein.

¹¹⁵ See Pavenstedt, "The Second Circuit Reaffirms the Efficacy of Restrictive Stock Agreements To Control Estate Tax Valuation," 51 MICH. L. REV. 1 at 6 (1952).

¹¹⁶ See Proposed Regs. under 1954 Code, §20.2031-2(h), 21 FED. REG. 7867 (1956).

¹¹⁷ See, e.g., *Lomb v. Sudgen*, (2d Cir. 1936) 82 F. (2d) 166; *May v. McGowan*, (2d Cir. 1952) 194 F. (2d) 396.

during his life as well as upon death,¹¹⁸ (2) the agreed price upon an inter vivos transfer under the agreement cannot be higher than upon death,¹¹⁹ (3) the estate must be bound to sell at death, either absolutely or at the option of the specified purchaser,¹²⁰ (4) the agreement must contain a stipulated price or a technique for determining the price,¹²¹ (5) and the agreement must have been a good faith, arm's-length transaction entered into for full and adequate consideration as of the time it was signed.¹²² An option in the prospective purchaser will have the same binding effect on valuation as a mandatory purchase (buy-sell agreement) if all the required elements are present.¹²³ The Commissioner and the courts will examine more closely agreements between related parties since the elements of full and adequate consideration, good faith, and arm's-length bargaining may be missing.¹²⁴ The omission of good will as a factor in setting the price may also subject the transaction to greater scrutiny.¹²⁵ The failure to include a proportionate share of the insurance proceeds in the computation of the decedent's interest under an insurance-funded entity plan may also reflect upon the adequacy of consideration, good faith, and arm's-length bargaining.¹²⁶

As can be seen from the above summary, the more accurately the price or price-fixing method in the agreement approximates actual value the more likely the Commissioner is to accept that price as determinative for estate tax purposes. Thus, the draftsman has an additional reason for trying to give the parties a "fair" price. Presumably, a capitalization of earnings method or other formula which takes a number of factors into consideration would be the most acceptable to the Commissioner since it represents

¹¹⁸ See, e.g., *Estate of James H. Matthews*, 3 T.C. 525 (1944), acq. 1944-1 CUM. BUL. 19.

¹¹⁹ See *Baltimore Nat. Bank v. United States*, (D.C. Md. 1955) 136 F. Supp. 642 at 654.

¹²⁰ See, e.g., *Estate of Lionel Weil*, 22 T.C. 1267 (1954), acq. 1955-2 CUM. BUL. 10.

¹²¹ See, e.g., *Brodrick v. Gore*, (10th Cir. 1955) 224 F. (2d) 892.

¹²² See *Edith M. Bense*, 36 B.T.A. 246 at 253 (1937), affd. (3d Cir. 1938) 100 F. (2d) 639; Proposed Regs. under 1954 Code, §20.2031-2(h), 21 FED. REG. 7867 (1956).

¹²³ See Friedman, "Buy and Sell Agreements: A Review and a New Look," N.Y. UNIV. 15TH INST. ON FED. TAX. 1053 at 1078 (1957).

¹²⁴ See Rev. Rul. 54-77, 1954-1 CUM. BUL. 187 at 193-194; *Claire Giannini Hoffman*, 2 T.C. 1160 (1943).

¹²⁵ See *Estate of George Marshall Trammell*, 18 T.C. 662 (1952), acq. 1953-1 CUM. BUL. 6; Rev. Rul. 157, 1953-2 CUM. BUL. 255; Proposed Regs. under 1954 Code, §20.2031-3, 21 FED. REG. 7867 (1956).

¹²⁶ Proposed Regs. under 1954 Code, §20.2042-1(c)(6), 21 FED. REG. 7886 (1956). See note, 71 HARV. L. REV. 687 at 693-694 (1958); Friedman, "Buy and Sell Agreements: A Review and a New Look," N.Y. UNIV. 15TH INST. ON FED. TAX. 1053 at 1073-1076 (1957).

an obvious attempt to reach a fair arm's-length valuation.¹²⁷ However, the courts have equally sustained other methods, such as book value,¹²⁸ par value,¹²⁹ and fixed price¹³⁰ even where the discrepancy between the restricted price and actual value was considerable. The addition of a provision for periodic renegotiation of a fixed price would seem to reinforce the binding nature of the restricted price since it tends to reduce even more that discrepancy. This is subject to a caveat, however, in the case of related parties who might use such an arrangement to set a high price when an inter vivos sale was contemplated and a low price when death was anticipated.¹³¹

The methods that are subject to the most doubt as to their binding effect on the Commissioner are appraisal and arbitration. Hornstein states that the federal taxing authorities "are not bound by a price to be determined by appraisers or arbitrators."¹³² He cites no authority for this proposition, however, and none has been found by this writer. Koch asserts that "the purchase price must be capable of being ascertained pursuant to the provisions of the buy and sell agreement."¹³³ But the case law is silent on this question and it does not appear to have been squarely presented to a court. The rationale of the concept that a restricted price *can* limit the valuation for estate tax purposes, however, does not seem to support this notion of ascertainability. If the stock can be sold only for a certain price, it has no greater value to the decedent or his estate than that price. The fact that the price is not readily ascertainable from the face of the agreement does not alter its restrictive quality. The time necessary to ascertain the price under a complex formula or book value method may be longer than that necessary for an appraisal by an independent third party. And a precise dollars-and-cents figure may be as

¹²⁷ See Swados, "Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement," 26 FORDHAM L. REV. 189 at 193 (1957).

¹²⁸ See, e.g., Estate of Lionel Weil, 22 T.C. 1267 (1954), acq. 1955-2 CUM. BUL. 10.

¹²⁹ See, e.g., Helmholtz v. Commissioner, 28 B.T.A. 165 (1933), affd. on other grounds (D.C. Cir. 1934) 75 F. (2d) 245, affd. 296 U.S. 93 (1935).

¹³⁰ See, e.g., Wilson v. Bowers, (2d Cir. 1932) 57 F. (2d) 682.

¹³¹ See Edith M. Bensel, 36 B.T.A. 246 (1937), affd. (3d Cir. 1938) 100 F. (2d) 639; WARREN AND SURREY, FEDERAL ESTATE AND GIFT TAXATION 611 (1956). See also note, 71 HARV. L. REV. 687 at 692, n. 24 (1958).

¹³² Hornstein, "Arbitration in the 'Incorporated Partnership,'" 12 ARB. J. 28 at 29 (1957).

¹³³ Koch, "Estate Planning and Tax Aspects of the Buy and Sell Agreement," 5 J. AM. SOC. OF CHARTERED LIFE UNDERWRITERS 65 at 75 (1949).

obscure from the face of the agreement when the former methods are used as the latter. The real test should be whether the decedent's stock was subject to sale at a price fixed under a predetermined method rather than being saleable without limitation on price. Thus where the agreement requires a sale but omits a price or price-fixing device, there has been no effective limitation on the price at which the stock must be transferred and its value has been affected only insofar as the range of prospective purchasers has been narrowed to a designated group. Where, however, the estate is bound to sell at a price set by an independent third party, the value of the stock has been as effectively limited as if the price had been set by an independent formula. This is even more evident where a fixed price plus renegotiation method has limited the price, and the mere addition of appraisal or arbitration as an alternative method in no way undermines the restrictive character of the price-fixing provision. Where the agreement specifies only that the price is to be determined by the parties at the time of death and, if they cannot agree, then by arbitration, the actual use of the arbitrator's valuation should bind the Commissioner. If, on the other hand, the arbitration is not utilized because the parties themselves have agreed, the Commissioner is still free to attack the price as not having been reached by an arm's length deal or for full and adequate consideration.

Until some case law definitively answers these questions, the area of appraisal or arbitration is not free from doubt. The use of these methods, either independently or in conjunction with others, is a question of judgment for the draftsman who must weigh the risks of adverse tax consequences against the anticipated advantages of the methods. Some comfort may be taken in the likelihood that a price fixed by appraisal or arbitration will be close to the "true" value, although there is no assurance that the Commissioner will agree as to what is "true" value.

Another price-fixing decision which may be affected by tax considerations is whether to provide for a cheaper take-over on certain transfers, like early retirement, than on others, like death. The fact that a formula or book value method inherently permits such variations does not appear to change the binding effect of the restrictive price upon estate tax valuation.¹⁸⁴ But if the agree-

¹⁸⁴ See note, 71 HARV. L. REV. 687 at 692 (1958).

ment uses different methods for different events, such as "book value" upon death but 80 percent of "book value" on voluntary retirement, some contention may be made that the restricted price is not binding on the death of the stockholder for estate tax purposes.¹³⁵ Such a contention ought not to be sustained, however, since the cases seem to regard agreements as not binding only when an inter vivos transfer price can be *higher* than the price on death.¹³⁶ The estate tax danger is that the parties will provide for inter vivos transfers at a fair price but reduce that price at death to minimize estate taxes. No such danger is present in the provision which merely attempts to value the stock somewhat lower when a stockholder voluntarily leaves the corporation than when he is forced to withdraw. The value at death, which is the only important consideration for estate tax purposes, is unaffected by this inter vivos modification. Nevertheless, the draftsman may conclude that the absence of such a variation would make the agreement "cleaner" for tax purposes. This would be especially true where the corporate entity is the purchaser because the percentage feature might accentuate the non-corporate purpose of the entity agreement, thereby subjecting the redemption payments to treatment as constructive dividends to the surviving stockholders.¹³⁷

¹³⁵ Cf. *ibid.*

¹³⁶ See, e.g., *Baltimore Nat. Bank v. United States*, (D.C. Md. 1955) 136 F. Supp. 642 at 654.

¹³⁷ Compare *Ray Edenfield*, 19 T.C. 13 (1952), and *Tucker v. Commissioner*, (8th Cir. 1955) 226 F. (2d) 177, with *Joseph R. Holsey*, 28 T.C. 962 (1957). Also see *Emeloid Co. v. Commissioner*, (3d Cir. 1951) 189 F. (2d) 230; note, 71 HARV. L. REV. 687 at 702-707 (1958).