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## ***Davis & Company, CPA's, CVA's***

### ***Sheryl A. Herron v. John T. Herron, 2004-Ohio-5765.***

The Ohio Court of Appeals for the Third District affirmed the **book value** valuation of a closely held business based on the terms of the buy/sell agreement.

At the same time of gifting shares by the mother and sole stockholder to her children, the three children entered into a buy/sell agreement. One of the children was the party in the divorce. The buy/sell agreement limited the ability of the stockholders to transfer the company stock and gave the stockholders the right to purchase at book value the shares of any other stockholder who attempted to sell his or her shares.

When determining the value of a corporation for the purpose of a property division in a divorce, the trial court must determine the corporation's fair market value. Fair market value typically reflects the price that would be agreed upon between a willing seller and a willing buyer in a voluntary sale on the open market. Book value is the value of an asset carried on the balance sheet, and often is lower than fair market value since it does not reflect any inherent goodwill of the business.

According to the Court of Appeals, the trial court did not rely conclusively on the book value of the company stock in determining its value. Rather the court considered the buy/sell agreement and the book value of the stock in determining what a willing buyer would be prepared to pay a willing seller on the open market. The trial court determined that the buy/sell agreement and the ability of the other stockholders to purchase the shares at book value would lower the expected fair market value of the stock.

The Court of Appeals affirmed the trial court's decision and added "Any willing buyer would certainly take into account the buy/sell agreement before making any offer on the stock. In fact, it would have been an abuse of discretion for the trial court to determine the company's fair market value without considering the buy/sell agreement and the book value."

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### **Valuation Commentary**

My questions are was the fractional interest in stock of the company valued or the entire company valued and then reflected in the fractional stock price? And, which approach is more appropriate in marital court?

The buy/sell agreement is only one fact that needs to be considered in the business valuation process. The trial court found that the agreement was put into place to protect the company from coming under the control of people or entities outside of the family so it was likely to be enforced. But the court also recognized that the share gifting was part of “an extended estate planning device.” For estates and gifts, the Internal Revenue Service will often look beyond the value determined by buy/sell agreements in family settings like this one because of family attribution and control issues. Further, most estate plans are structured to intentionally reduce value to ultimately result in lower estate taxes.

If the court is only considering the value of the shares in the hands of the shareholder, the terms and validity of the buy/sell agreement can be a key fact. But what if the entire company was sold and not only the fractional share interest? I am not sure if this question was ever raised in the case. Now the issue of size of the block of shares and company control become important facts.

A minority shareholder cannot often influence the sale of the company, but agreement between family members can, depending on the relationships. More importantly, other external forces can have an influence on the sale of the entire business. For example, outside factors like entry of a new competitor into a marketplace, increase or decline in sales or market share, or industry consolidation can have a big influence on a decision to sell the company. This being said, if the entire company was sold, would the buy/sell agreement between the stockholders even matter? A bit rhetorical maybe, but certainly worthy of consideration.