Buy Sell Agreements

INTRODUCTION

This paper will address issues that arise in a divorce case where one spouse's interest in a business or a professional practice is subject to a buy-sell agreement. In all cases, it is essential to first ascertain whether there is any kind of partnership or shareholder agreement. Every attorney's interrogatories should specifically include that question. Yet, if partners or shareholders have a buy-sell agreement, does that end or merely begin the analysis as to value. Should it be determinative as to value? Is the issue one of valuation or distribution? Should there be a bright line rule or a multi-factoral analysis? Do the cases that address the issue do so consistently with the statutory equitable distribution purpose or is their analysis merely superficial? This article will attempt to identify the issues raised when there is a buy-sell agreement, review the existing law and suggest an approach that the author feels is most consistent with the policy underpinning equitable distribution.

LEGAL FRAMEWORK

Our Supreme Court has considered buy-sell agreements and equitable distribution on two separate occasions. In Stern v. Stern, 66 N.J. 340 (1975), a case involving the valuation of a partnership interest in a law firm, the Court found "the monetary worth" of such a partnership consisted of the total value of the partner's capital accounts, accounts receivable, work in progress, the value of tangible property, along with good will, diminished by

Ten ICLE 6/24/95

The Supreme Court again considered buy-sell agreements when it reversed a trial level decision requiring parties to remain as partners in the face of disparate values for a business. Bowen v. Bowen, 96 N.J. 36 (1984). In Bowen, the husband's twenty-two percent interest in Polycel, which had gross sales of over $3,000,000.00 was valued by the husband at $70,854.00 and by the wife at $338,279.00. Confronted with these values, the Trial Court simply ignored them and left the parties as partners. Ultimately, the Supreme Court reversed noting that such an approach had potential for "strife and friction" which was one of the more perceptive observations by our Supreme Court. Bowen at 43.

In approaching the buy-sell agreement, upon which neither expert relied upon, the Court reasonably observed that the value people place upon an asset is a "most productive place" to start an inquiry. Bowen at 45. The buy-sell agreement in Bowen was not atypical. It required before there could be a transfer of stock that it first be offered to the other shareholders at the price computed in the agreement. That price was entirely unrelated to fair market value. It was the "book value" determined by the corporate accountant. Bowen at 46. The Court acknowledged that the formula "specifically excluded good will" and that the agreement also provided for installment payment over years. It further required the parties periodically revise the agreement which they never did. Certainly, any agreement that required one party to sell their interest at book value is entirely unrelated to fair market value. Two partners, however, negotiating an arm's

length agreement with full knowledge of their circumstances relating to retirement and the likelihood of being either a buyer or a seller is a distinctly different set of circumstances than in determining what the fair compensation should be to a dependent non-titled spouse for an asset acquired during the marriage. In one instance, there are policy considerations relating to the enforcement of freely negotiated contracts and in the other, the policy considerations requiring fairness in the division of assets acquired in the context of the intensely personal marital relationship. The policy considerations are entirely different. It is, therefore, not surprising that the Bowen Court declined to utilize a non-updated book value buy-sell agreement as being determinative as to value for equitable distribution purposes.

In language that rejected the basis upon which the Stern Court relied and, in effect, eviscerating reliance upon buy-sell agreements in divorce cases, the Court said the buy-sell agreement should not control because it "did not contemplate the circumstances when the stockholder status or the corporation and fellow stockholders was to remain the same" Bowen at 46-47. In other words, aside from all of the other problems, why would a Divorce Court rely on an agreement negotiated on the basis that one of the partners would be leaving. In a divorce it is a reality that the titled spouse would not be leaving but staying. If it were otherwise, the sales proceeds could be divided yet in a divorce nothing is being sold. The Bowen Court perceptively recognized in equitable distribution the asset was not being sold.

Yet, that concept hasn't been incorporated in the valuation process. See generally Louis, Equitable Distribution Value: An Alternative To Fair Market Value annexed hereto.

The Bowen Court further reasoned that under such circumstances to reflect "a fair value" Polycel's good will should have been included. Bowen at 47. Despite it's rejection of the buy-sell agreement establishing fair market value, the Court acknowledged it could not be "facially dispositive," but still noted the agreement had to be considered "in light of all of the circumstances". In determining that it had to be "considered", it relied on Revenue Ruling 59-60 at Section 8 which provides in pertinent part as follows:

> "Frequently, in the value of closely held stock for estate and gift tax purposes, it will be found that the stock is subject to an agreement restricting its sale or transfer. Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes. However, in such case the option price is not determinative of fair market value for gift tax purposes. Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value. Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bona fide business arrangement or is a device to pass the decedent's share to the natural objects

> of his bounty for less than an adequate and full consideration in money or money's worth. (emphasis added)

The Court did not entirely reject the presumptive value approach in Stern. It suggested that in addition to the calculation required by the agreement, good will would be determined and then added to the fair amount calculated under the buy-sell. Bowen at 47. One wonders whether the Supreme Court really understood that what they were really saying hardly reduced disputes in valuing a closed corporation. In almost all cases, the primary dispute involves the amount of good will, not so much the value of the fixed assets. Buy-sell agreements would hardly serve to reduce or minimize litigation over valuation of these interests. Use of the buy-sell agreement would perhaps minimize only one relatively minor valuation dispute. In reaching its conclusions, the Court rejected the husband's contention that it would be unfair not to consider the agreement as binding because that is all he would receive under the agreement. The Court made short shrift of this contention arguing there would be "no reason" to sell shares since the Court could fashion a distribution so a sale need not occur. This ignored the question of the fairness of an owner compensating a spouse under fair market value concepts and then having one of the contingencies occur and being compensated (under the Buy-Sell) for the same interest at a significantly reduced rate. That problem will be addressed later in this article.

The Stern rationale of not accepting the agreement because it neither reflected fair market value or was being applied for a

the non-titled spouse never agreed.

THE POLICY CONSIDERATIONS

In all of the cases, there was never a discussion of the juris prudential relationship between a buy-sell agreement and the statutory purposes of equitable distribution. It was always assumed that the issue was whether the buy-sell agreement determined value, not how a buy-sell agreement interrelated with the policy considerations inherent in effectuating distribution of assets in a divorce. Equitable distribution is a recognition of how New Jersey, as a matter of public policy, views marriage. Marriage is considered a partnership and to a large extent, it is not pertinent to the Court which spouse actually contributed to acquisition of the asset since the law presumes that while married each party made "a substantial financial or nonfinancial contribution to the acquisition of income and property". See N.J.S.A. 2A:34-23.1. As the Supreme Court indicated in Rothman, equitable distribution recognizes:

> "the essential support of role played by the Wife in the home, acknowledging that as a homemaker, Wife and Mother, she should clearly be entitled to a share of assets accumulated during the marriage. Thus, the division of property upon divorce is responsive to the concept that marriage is a shared enterprise, a joint undertaking, that in many ways it is akin to a partnership. Only if it is cleary understood that far more than economic factors are involved with the resulting distribution be equitable within the true intent and meaning of the statute." Rothman at 229. (emphasis added)

While equitable distribution is an evolving concept, there is a continuing refrain that reappears in the cases. Despite all the

technical rules and the arguments made, in the final analysis a Court's goal in effectuating an equitable distribution of assets is relatively simple - to assure the distribution is equitable. That simple fundamental principle is the bedrock upon which equitable distribution is based. It is also the heart of the developing concept of changes in value between the filing date of the Complaint and was recognized as long ago as 1975 by the Appellate Division in Scherzer v. Scherzer, 136 N.J. Super. 397, 400 (App. Div. 1975). There, the Appellate Division reaffirmed the basic legislative policy that, in the final analysis, the distribution of property must be "equitable". Similarly, that was the basis for Judge Glickman's perceptive decision in Goldman v. Goldman, 248 N.J. Super. 10 (Ch. Div. 1991) (aff'd. 275 N.J. Super. 452 (App. Div. 1994). If the distribution is unfair almost by definition it is not equitable. See, Louis, Determining Valuation of Property After Divorce, 12 N.J.F.L. 113 (Aug. 1992).

Presentation of this issue must never lose sight of that simple fundamental fact. All arguments must be based upon the fairness of the distribution and not whether the distribution is in accordance with technical rules. We should never elevate form over substance which had led me to conclude that there cannot be a single bright line rule for the inter-relationship between Buy-Sell Agreements and Equitable Distribution. In the final analysis, two partners in the same professional practice, each getting divorced at the same time and each relying on the same Buy-Sell Agreement might not be treated the same in their respective divorces. Blind

adherence to only one fact, without regard to any other circumstances, may satisfy those who elevate simplicity over justice but that is fundamentally inconsistent with the statutory and public policy considerations inherent in our equitable distribution scheme.

I have identified a number of factors that I believe should be considered by the Court in determining the place of a Buy-Sell Agreement in any equitable distribution scheme. The fact that I am relying on this multi-factoral analysis is corroborative of my view that the primary issue involved in a Buy-Sell Agreement is not what is the value of the asset but how that asset is to be distributed. Only in the analysis of the statutory factors, which are distribution as opposed to valuation factors, can the Court be assured that its final result will be fair and hence equitable.

One must never lose sight of the reality that assets are valued in a divorce case not because they are being sold, which they normally are not, but because the asset has value which must be divided in some way as a consequence of the marriage's dissolution. The law assumed that the fairest way of effectuating this division is to determine the fair market value of the asset and then divide that value in accordance with the legislatively approved statutory factors. The economic reality, however, is somewhat different. The real value to the spouse of the business is not it's fair market value, which assumes a sale; but the value to the person who continues to own the asset. That concept is fundamentally at variance with the assumptions in a Buy-Sell

Agreement which was only executed to deal with circumstances predicated upon a sale. It is for that reason, among others, that my earlier article is attached to emphasize the importance of having equitable distribution recognize the reality in a divorce case which is far different than the context in which a Buy-Sell Agreement might be interpreted in other areas of law. Quite simply, since the asset is not being sold, there must be some recognition, not on the valuation but on the distribution side, of that reality.

In this context it is interesting to compare how Buy-Sell Agreements are treated under Revenue Ruling 59-60 (the same Revenue Ruling appraisers use to value assets) in the event of death. Shannon Pratt indicates in his treatise that the price established by a Buy-Sell Agreement may be binding on the IRS for estate tax purposes, even if it is lower than that which would be established under the Revenue Ruling 59-60 at the time of death under some circumstances. Thus, Pratt and Stern are in fundamental disagreement as perhaps they should be given the difference between death and divorce. In the latter, the owner continues to operate or own the asset. The statutes and the policies involved are entirely different.

In Pratt's view, the most important factor is the extent to which the price was established on an arm's length basis. See, generally, Pratt Valuing A Business (2nd Ed. 1989) at p. 515. The obvious distinction, even though value in each instance is calculated on Revenue Ruling 59-60 is that there are no other

benefits to the decedent's estate other than what is received under the Buy-Sell Agreement because one of the pre-conditions is that death has occurred. The exact opposite is true in a divorce case.

None of these comments should be construed as suggesting that there should be a diminution of the importance of a Buy-Sell Agreement in equitable distribution. It is a matter of simple economics and common sense that any restriction on the alienability of an asset has a direct impact on value. There are ample studies on how publicly traded stock which are subject, for example, to sale limitations under Section 14, have diminished value. Common sense will tell you that a Restrictive Covenant which limits the ability to develop real estate also adversely impacts on the value. It is the role of the advocate to demonstrate how a Buy-Sell Agreement impacts on the economic value on the part of the owner. If the factors of your divorce case demonstrate that the likelihood, for example, that the Buy-Sell Agreement would be implemented within a foreseeable period of time, that is such a significant limitation on the benefits the holder will, or even could receive, from the asset these facts must be reflected either in the valuation or the distribution phase of the case. (I opt for the distribution phase.) The difficult issue is where to draw the line, i.e. - the Agreement will not materially effect the true economic value of what the titled spouse is receiving as opposed to where it does. It is an extremely fact sensitive analysis and the advocates role is to mold the legal framework with the facts of the case to demonstrate the impact upon the titled spouse while

simultaneously demonstrating the impact on the non-titled spouse so that a Court can in the totality make a judgment about what is fundamentally fair. If occurrence of a contingency triggering the agreement will shortly occur a substantial argument exists the question is value not distribution but clients care nothing about theory. Their interest is the bottom line. Our job is to present facts to establish why, or why not, a certain result is fair. Focus on the why (the fairness) not the how (distribution or valuation).

An analysis of the out-of-State cases is interesting, if not instructive. It appears that the basic majority view is that the price fixed in a partnership or corporate Buy-Sell Agreement is not considered binding for equitable distribution purposes when the other spouse did not consent to or was not otherwise bound by its terms, but, nonetheless, is a factor to be considered in the approach suggested here. In re: The Marriage of Keyser v. Keyser, 820 P.2d. 1194, 1197 (1991); Bosserman v. Bosserman, 384 S.E. 2d. 104 (Va. App. 1989); Bettinger v. Bettinger, 396 S.E. 2d. 709 (W. Va. 1990); Mitchell v. Mitchell, 732 P. 2d. 208 (1987); In re: Marriage of Slater, 160 Cal. Rptr. 686 (1979); In re: Marriage of Hall, 692 P.2d. 175, 179 - 180 (Wash. 1984); Huff v. Huff, 834 P. 2d. 244 (Col. 1992); Suther v. Suther, 627 P. 2d 110 (Wash. 1981).

There is a small minority of cases holding that a Buy-Sell Agreement, even one expressly precluding consideration of good will, is determinative as to value. See, Hertz v. Hertz, 657 P. 2d 1169 (N. Mex. 1983); Finn v. Finn, 658 S.W. 2d. 735 (Tex. Ct. App.

1983). See, also, Holbrook v. Holbrook, 309 N.W. 2d. 343, 355 (Wis. Ct. Ap. 1981) (Court noted a "disturbing inequity in compelling a professional practitioner to pay a spouse a share of intangible assets at a judicially determined value that could not be realized by a sale ..."). These Courts, as the quote from Holbrook make clear, found any requirement to pay a spouse for good will as to which the owner had no legal right to enjoy was unfair and, therefore, limited the non-titled spouse's entitlement to the value the titled spouse might receive - and nothing more. These Courts' findings are predicated upon what they perceive to be fundamental fairness. If the owner is not being paid for good will, they argue, how could it possibly be fair to require a payment to a spouse for something that the owner will never receive. Translating that argument into our law, such a requirement would be "inequitable" and therefore contrary to the legislative intent.

THE PROPOSED FACTORS

Consideration of the existence of a Buy-Sell Agreement in the distribution phase of equitable distribution is not entirely unlike considering theoretical tax consequences under Orgler. The degree to which it is considered is left to the sound discretion of the Court based on an analysis of the pertinent factors that bear on the fairness of the distribution. The factors set forth in this article are not necessarily intended to be complete. Hopefully, at this seminar, other panelists will not only critique these but add others. In evaluating the factors, what must never be forgotten is

that these factors, and the entire issue, must be analyzed not in a vacuum but from a standpoint in assuring that the public policy considerations in effectuating an equitable distribution of assets is implemented. The contributions of the non-titled souse must be considered but should not be determinative. They must be analyzed in the context of the economic impact of the agreement. Underpinning this analysis is the salutary principle recognized in Scherzer and Goldman that pre-eminently whatever distribution is selected, it must be one that is equitable and fair.

An example illustrates the analysis that must be undertaken. When one values an asset for purposes of equitable distribution, it is generally done based upon the cash flow and the income stream generated by the asset. There are obviously exceptions to that generalized statement but for illustration purposes, it emphasizes the point. If the buy out figure in the Buy-Sell Agreement is set at such a low figure that the non-titled spouse does not receive the benefits of the titled spouse's continuing ownership of the asset, either through equitable distribution of that asset, others, or through support (alimony or child support), then the final result would be unfair. If, however, the cash flow generated by the asset, through support for instance, is channeled to the non-titled (and generally dependent spouse), then in the final analysis, both parties are treated fairly. The titled spouse is not required, as the husband argued in Bowen, to pay the spouse more than could be received as the owner as a consequence of the Buy-Sell Agreement. Yet, if the dependent spouse and the children

receive the benefit of the asset's ownership then the result would be fair. If there were a certain set of circumstances, such as an impending remarriage, where alimony would not fairly compensate the non-titled spouse for the inherent value in the asset (i.e. cash flow), then the percentage awarded in the asset might well be higher notwithstanding the Agreement. Otherwise, if alimony and child support compensates the non-titled spouse for the true economic value of the asset, then the Buy-Sell Agreement should have a material and significant impact on the percentage the non-titled spouse receives on the fair market value. If a Court was to award the non-titled spouse forty percent (40%) of an asset valued at $500,000.00, <u>without</u> a Buy-Sell Agreement, the existence of a Buy-Sell Agreement which circumscribes the ability of the titled spouse to sell the asset at anywhere near $500,000, should result in a sharply reduced percentage. In this analysis, that end result must be fair and is subject to the unique facts of the case as well as the additional factors outlined hereafter. Such an approach recognizes the complaint of the business owner who argues that if support is predicated on cash flow as well as valuation, isn't there a double dip?

The factors are as follows:

1. Does the Agreement reflect fair market value?
2. Whether the Buy-Sell Agreement has been used in other transactions involving partners or shareholders.
3. The likelihood that the Buy-Sell Agreement, despite its terms and perhaps even the regularity of its update, would be implemented.
4. Was there an attempt in determining the buy out figure

to ascertain what fair market value really was? Was the buy-out figure the amount they could afford to pay for life insurance?

5. The level of child support and alimony to be paid.

6. Has the Agreement been regularly updated?

7. What are the components of the formula?

8. What is the likelihood of the owner continuing with the business?

9. What is the degree of control, if any, possessed by the titled spouse?

10. What benefits (salary, perks, appreciation, unreported income) will the owner continue to receive in the future?

11. The age of the owner (i.e. this impacts upon the proximity of implementation of any agreement).

12. The existence, form and liquidity of other assets.

13. Did the non-titled spouse sign or otherwise agree to the Buy-Sell Agreement?

14. Was the Buy-Sell Agreement prepared for legitimate business reasons or in contemplation of a divorce?

It is appropriate to comment on why some of the factors have been included although some are fairly self-explanatory. Obviously, in the light of the foregoing discussion, the likelihood of the owner continuing with the business and the benefits that flow from that ownership are pertinent factors in evaluating the fairness. The age of the owner becomes as important in evaluating a Buy-Sell as it does in the Orgler tax consequence circumstance. The older the owner, the more likely that the Buy-Sell figure will be received by that individual. The younger the owner, there is a reduced likelihood that the owner would be receiving that amount in

the near future and, hence, would continue to receive the benefits of ownership.

Some of the factors are directed to the likelihood of the Buy-Sell Agreement ever being actually implemented. They involve whether there were other transactions under the Buy-Sell Agreement, the generalized factor of the likelihood and the question of control. The greater the control of the titled spouse, the greater the ability to change the Buy-Sell after a divorce.

A Court weighing each of these factors on the unique circumstances of the case will more likely be able to fashion a result that more fully implements the statutory purposes. It must never be forgotten that a Buy-Sell Agreement is not a divorce document. It must be interpreted in the common sense way in recognition of the fact that there is a divorce that is occurring. It is hoped that this article will place the issue in perspective and result in judicial determinations and settlement that, in the final analysis, are fair to both sides which is, and must always be, the goal of our system of justice.

FRANK A. LOUIS

DATE: June 7, 1995