



“How Not to Do” Buy-Sell Agreements

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Ehlinger v. Hauser:

“How Not to Do” Buy-Sell Agreements

By L. Paul Hood Esq.

In this state court action, the appellate court affirmed the trial court’s determination that the term “book value” was sufficiently ambiguous to render the terms of a disability buy-sell agreement unenforceable. *Ehlinger v. Hauser*, 2007AP477 (Wisc. App. IV July 24, 2008).

Facts

Jon and Bill, a dentist, were friends and decided to form and co-own a picture framing company. Jon worked in the business full-time. In 1992, just a year before Bill discovered that he had Parkinson’s Disease, they entered into a buy-sell agreement that provided in pertinent part as follows:

6. Purchase Price.

- (a) For transfers of all of a Shareholder's stock at his death, or upon his becoming disabled, *the purchase price of a Shareholder's shares of stock shall be \$350,000.00 or Book Value[,] whichever is greater*, except if the Shareholders have determined by unanimous resolution passed subsequent to the date of this agreement that the purchase price shall be other than \$350,000.00, then the most recent such resolution shall determine the purchase price. For transfers of all of a Shareholder's stock on threat of involuntary transfer, the purchase price of a Shareholder's shares of stock shall be the book value of said shares as of the end of the last fiscal year. (Emphasis added.)

In June 2001, Jon triggered the disability buy-sell provision and offered to pay Bill the sum of \$431,400, which John represented was the corporation’s “book value.” Bill requested and received the right to audit the corporation’s books. Nevertheless, the parties parted as friends and sued each other. Jon sued to enforce the disability buy-sell provision; Bill countersued to involuntarily dissolve the corporation and also argued that the buy-sell agreement was unenforceable due to ambiguity and further that he was not disabled for purposes of the buy-sell agreement.

At trial, the results were mixed. The trial court held that the buy-sell agreement was enforceable despite the ambiguity and further that Jon was in fact disabled for purposes of the agreement. However, the trial court also held that Bill was entitled to judicial dissolution due to the corporation’s failure to elect directors for two years, that the

agreement term “book value” (which was not defined in the buy-sell agreement) was to be interpreted according to generally accepted accounting principles (“GAAP”), that the corporation’s financial statements and supporting documentation lacked sufficient detail to determine whether the financial statements had been prepared in accordance with GAAP and that the failure of the term “book value” rendered the disability buy-sell agreement unenforceable. Jon and Bill both appealed.

On appeal, the appellate court affirmed all of the trial court’s holdings. The appellate court noted:

we conclude that the term “book value” as used in the Agreement is not indefinite but is ambiguous, and that the most reasonable construction of that term is that it refers to a computation using generally accepted accounting principles. We conclude further that the absence of information necessary to complete the GAAP analysis rendered the disability buyout provisions unenforceable because [the corporation’s] book value as of March 31, 2001, could not be determined.

Comments

The result seems correct on all scores. However, there are lots of lessons of “how not to do buy-sell agreements” in this case.

Given that Bill was not active in the day-to-day operations of the corporation (I strongly suspect that he was the moneyed partner), WHY HAVE A DISABILITY BUYOUT TRIGGER FOR BILL AT ALL??? How was Bill’s failure to be able to practice DENTISTRY even relevant to his remaining a shareholder of a PICTURE FRAMING COMPANY that had 30 employees? I can understand a disability buyout trigger for Jon since he was a full-time employee of the corporation, but I can’t understand one for Bill. This possibly came into the buy-sell agreement as boilerplate, which can be dangerous and expensive! One needn’t have the same triggering events for all owners.

The disability trigger in this buy-sell agreement failed to define disability, which was downright dumb. There are lots of different potential definitions of disability. For example, there is so-called “own occupation” disability—inability to practice one’s occupation, e.g., dentistry, even though one could hold down some other job such as teaching dentistry. Then there is total disability, which Social Security Disability uses—the inability to work at all. In general, because disability can be a gray area, the disability trigger in a buy-sell agreement has to be much more carefully drafted than virtually any other provision in the agreement.

There are lots of potential ways that an allegedly disabled owner can duck and dodge the disability determination, and a well drafted provision should take these into consideration, e.g., refusing to submit to medical examination, refusing to

release medical information, showing up at work periodically, etc. The allegedly disabled person can be like a cornered animal.

This buy-sell agreement used the term “book value,” which almost never takes current value or goodwill into account. Moreover, this buy-sell agreement made no attempt to define what the term “book value” meant. In my opinion, there are very few if any situations in which a naked use of the term “book value” should be used in a buy-sell agreement. This is just a piece of lurking litigation.

In this case, the trial court decided to graft GAAP onto the definition of “book value.” However, this was not a foregone conclusion, and Bill originally fought its application since he argued that the agreement was totally unenforceable due to ambiguity. It is possible that the court would not have imported GAAP to its determination of the meaning of the term “book value.” Suppose the parties weren’t using GAAP to begin with? The bottom line: if one is going to use some sort of valuation formula (and this isn’t advisable) or some variant of book value, strongly consider spelling out that GAAP is to apply and if there are to be departures from GAAP, consider spelling those out as well.

The trial court appointed a special magistrate CPA to determine whether the corporation’s financial statements were prepared in accordance with GAAP and whether there were any departures from GAAP. Due to the corporation’s failure to maintain sufficient GAAP records, the special magistrate CPA could not opine that the corporation’s financial statements were in fact maintained in accordance with GAAP, which, reasoned the court, rendered the term “book value” sufficiently ambiguous to be unenforceable.

Use of the term “book value,” even if defined in detail, is rarely advisable in a buy-sell agreement because it could be susceptible of manipulation. Book value does not factor in income-earning potential. Suppose that the business was a low capital business such as a service business? The human capital component does not get factored in under a book value arrangement.

Even though it appears that Bill will get his wish and have the corporation dissolved, this will be a pyrrhic victory at best. On dissolution, he will probably not get compensated at all for the earning power or goodwill of the corporation and will face double taxation—at the corporate level and at the shareholder level. The parties would be better off settling. Playing dissolution chicken only benefits the silent partner—Uncle Sam. Meanwhile, 30 people are likely to be put out of work—by a poorly drafted buy-sell agreement!

Citation

Ehlinger v. Hauser, 2007AP477 (Wisc. App. IV July 24, 2008).

The Author

A native of Alexandria, Louisiana, Paul received a J.D. from Louisiana State University Law Center in 1986 and a Master of Laws in Taxation from Georgetown University Law Center in 1988. Paul taught the estate and gift taxation course in the Graduate School at the University of New Orleans. He is a Fellow in the American College of Trust and Estate Counsel.

Paul serves on the BNA Tax Management Estate, Gift and Trust Advisory Board in Washington, D.C. He previously served as a member of the Trust Code Committee and the Charitable Trust Law Committee of the Louisiana State Law Institute. Paul previously served as a member of the Tulane Law School Estate Planning Institute Advisory Committee. He has been qualified as an expert witness in several courts in estate planning and in tax, probate and trust matters. Paul has been appointed as a special master by Louisiana district courts.

Paul has spoken at conferences sponsored by a number of law schools, including NYU, Duke, Georgetown, Tulane, LSU and Loyola (N.O.), and, as well as at conferences sponsored by many professional organizations, including LSBA, AICPA and many estate planning councils across the country.

Paul's articles have appeared in a number of national publications, including *Estate Planning*, *Probate Practice Reporter*, *BNA Tax Management Memorandum*, *CCH Journal of Practical Estate Planning*, *Digest of Federal Tax Articles*, *Loyola Law Review*, *Louisiana Bar Journal*, *Tax Ideas* and *Charitable Gift Planning News*. He is on the team that covers estate planning recent developments for Leimberg Information Services, an internet based estate planning professional newsletter. Paul recently revised BNA Portfolio 830, *Valuation: General and Real Estate*. He is consulted by, and is frequently quoted in, professional and business periodicals such as *Lawyers Weekly USA*, *Money*, *Fortune* and *The Wall Street Journal*.

Involved in numerous charitable, social and civic endeavors, Paul is a past chair of the Tax Section of LSBA, and he has served as an officer, and on boards, of numerous organizations. Paul served for a little over eight years on the three member Louisiana Board of Tax Appeals, Louisiana's tax court, as an appointee of Governor Foster.

Paul's practice is heavily concentrated in family business and wealth matters, including estate and trust planning, as well as estate and trust litigation. Paul represents families, beneficiaries, trustees, executors and foundations.

Paul lives in Mandeville, Louisiana, where he is active with his sons, Paul III, age 12, and Evan, age 9. A former graduate assistant in the LSU Athletic Department, Paul coaches baseball, and he is a paid pitching instructor who specializes in new pitchers from ages 9-14.