BRUEGGEMAN AND JOHNSON YEANOPLOS, P.C.

BUILDING VALUE

A Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

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Is Closely Held Stock Really 'Preferred'?

Preferred stock is a hybrid security that shares some of the characteristics of both common stock and bonds. Like shares of common stock, preferred shares represent an ownership stake in a company for which its shareholders have a claim on its assets and earnings. However, while preferred shares are considered "equity," they also have many of the same characteristics as a bond and other interest-bearing debt. And on a risk-return investment scale, preferred shares are much closer to bonds, etc. than to common shares since preferred shares have limited returns, limited growth potential, and are generally less risky.

While preferred stock shares may have advantages for a publicly held company and its shareholders, its benefits would likely be limited to a closely held company and its shareholders for several reasons. Consider the observations and characteristics in the following comparison of preferred shares of the two types of entities:

DIVIDENDS

Publicly Held Companies

Preferred dividends are usually paid by public companies at a (yield) rate that approximates the market rate for the security. Generally, public companies are better able to pay preferred dividends. Dividend coverage (the risk associated with a company's ability to timely pay dividends) is perceived as superior to that of closely held companies.

Closely Held Companies

Preferred dividends are paid at a rate that approximates the market rate for or at a rate that is acceptable to its owners. Dividends are generally paid if such companies are able to produce the necessary cash flows to pay the dividends. Generally, closely held companies are inherently more risky, and the probability of making timely and adequate referred dividend payments are likewise riskier.

POTENTIAL FOR VALUE APPRECIATION

Publicly Held Companies

Preferred shares will generally increase in value as common share values rise, but at a much lesser rate (%).

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Closely Held Companies

Usually, there is no market for closely held preferred shares, even if common shares increase in value. Potential investors in closely held companies are usually more interested in purchasing common equity interests.

MARKET / LIQUIDATION VALUE

Publicly Held Companies

There is an established market for preferred shares. As such, the shares can be liquidated at market price.

Closely Held Companies

Since there is no established market for preferred shares, it is harder for an investor to sell preferred shares to a third party and it may be harder for a company to redeem such shares due to inherent riskiness of its cash flows. Many closely held companies have provisions that offer a liquidating preference to preferred stock investors; however, such provisions are dependent upon adequate cash flows.

EXPERT TIP

Preferred shares in closely held businesses are generally subject to higher risks than preferred shares in publicly held companies, mainly because future cash flows (and thus dividend payments) may be less certain.

Let's further observe the investment potential of closely held preferred shares by considering a real-life scenario that focuses the viability of investing in preferred shares versus common shares: A CEO of a small, growing specialty wholesale electronics components closely held entity owned 15 percent of the common shares in that firm. The firm is a subsidiary of a foreign (parent) company that owns the majority of the common shares of the subsidiary. The CEO approaches the parent company's management about the possibility of acquiring an additional 15 percent common-share interest in the subsidiary.

The parent company's management counters with an offer to issue preferred shares of the subsidiary, all of which would be sold to the CEO and would pay a 6 percent annual dividend. The CEO seeks a valuation advisor's assistance and requests a valuation of the subsidiary's common shares. After performing the valuation and careful consideration of the two prospective alternatives, the advisor's overall analysis revealed the following: The subsidiary was a growing, profitable firm, regularly achieving excess earnings each year; thus, the CEO was well-thought-of and his services were highly valued by the parent company, and thus they desired to retain the CEO's services by rewarding him. It was further determined that, since the subsidiary was performing so well, the parent company did not want to sell any of its common shares and chose to appease the CEO by offering preferred shares to him.

Ultimately, the advisor recommended that the CEO insist that he consider conditioning his further employment upon an agreement to allow him to purchase additional subsidiary common shares for the following reasons:

1) The advisor's valuation determined that the expected earnings (and cash flow) and expected revenues growth were much greater than average, and the expected risk associated with such an investment in the common shares was relatively low. This, of course, translates into excellent potential for growth in commonshare value. More common shares would offer the CEO greater incentive in continuing to operate such a highly successful entity.

2) By acquiring preferred-share ownership, the CEO's returns would be fixed and limited; he would not be materially benefitting from the company's growth, even though such growth would be primarily due to his own efforts.

3) Preferred shares in closely held businesses are generally subject to higher risks than preferred shares in publicly held companies, mainly because future cash flows (and thus dividend payments) may be less certain.

4) Upside potential value in closely held preferred shares is very limited and is usually limited to the shares' liquidation value. Again, there is very limited potential for value growth.

Note: If the CEO purchased the preferred shares, this would almost be the equivalent of loaning funds to the subsidiary, since the closely held preferred shares contain characteristics similar to debt. In the author's opinion, the best return that an investor in closely held preferred stock could hope for is for the dividends to be paid on a timely basis during the investor's holding period and for the original investment to be paid back at a future date in accordance with the liquidation provisions of the governing agreement.

By Marvin T. Brown, CPA/ABV, CVA
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Debt versus Equity: How Do You Know?

One of the issues that valuation analysts deal with is whether a loan from a stockholder of a corporation (or a principal of any type of entity) is debt or disguised equity. In other words, is the stockholder loan recorded on the balance sheet truly debt, or did the accountant classify it as debt so the stockholder can pay himself interest and/or withdraw the monies over time? The alternative classification is stockholders' equity, which means the shareholder cannot withdraw the funds until he sells his interest in the entity or the entity is sold. In addition, if classified as equity, dividend payments are never a certainty, so there may be no current return for an equity investor. However, if classified as debt, sometimes interest payments are made.

One of the main factors that a valuation analyst considers in determining whether monies should be classified as debt or equity is the amount classified as common stock and paid in capital on the balance sheet. If this amount is low, the appraiser will most likely view the company as being undercapitalized and treat the "supposed" loan as equity. Why is this important? Since the value of a company will differ depending on the classification of stockholder advances as debt versus equity and the swing in value can be staggering if the amounts are large, the issue can have large consequences in the valuation process.

Of course, the Internal Revenue Service (IRS) is also interested in this issue because of the deductibility of interest payments by a corporation versus the non-deductibility of dividend payments. If the IRS can reclassify debt to equity, then interest payments are not deductible and there is more taxable income.

There have been several court cases that have dealt with this issue. One is *Fin Hay Realty Co. v. United States*.[1] In this case, the U.S. Court of Appeals for the Third Circuit listed 16 "criteria by which to judge the true nature of an investment which is in form a debt." These items included the following:

1) The intent of the parties
2) The identity between creditors and shareholders
3) The extent of participation in management by the holder of the instrument
4) The ability of the corporation to obtain funds from outside sources
5) The "thinness" of the capital structure in relation to debt
6) The risk involved
7) The formal indicia of the arrangement
8) The relative position of the obligees as to other creditors regarding the payment of interest and principal
9) The voting power of the holder of the instrument
10) The provision of a fixed rate of interest
11) A contingency on the obligation to repay
12) The source of the interest payments
13) The presence or absence of a fixed maturity date
14) A provision for redemption by the corporation
15) A provision for redemption at the option of the holder
16) The timing of the advance with reference to the organiztion of the corporation

In *Indmar Products Co., Inc.*,[2] a more recent case, the issue was whether interest payments were deductible. This hinged on whether shareholder advances were debt or equity. Indmar Products Co., Inc. (Indmar) manufactured marine engines. Historically, the company did not pay dividends. In addition, shareholders had always

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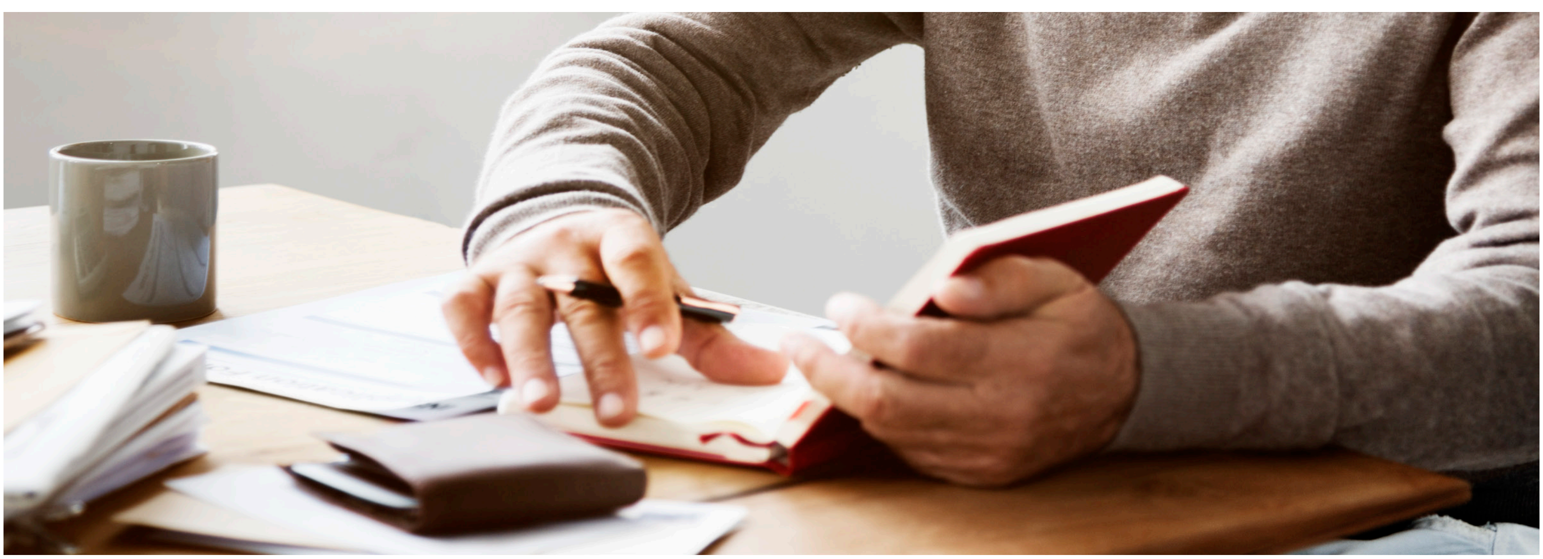

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made advances to the corporation and received monthly interest payments at a rate of 10 percent. However, these advances were never formally documented.

Beginning in 1993, Indmar and the shareholders executed promissory notes for all advances. The notes were payable on demand, freely transferable, had no maturity date or monthly payment schedule, and had a fixed interest rate of 10 percent. The company also maintained debt with a bank and agreed to make no principal payments on the stockholder advances for one year so the company would not violate the bank's loan agreement.

The Tax Court heard the case and ruled that the advances did not constitute debt, and therefore the interest payments were not deductible. The company appealed to the Sixth Circuit Court of Appeals (CA 6), which considered 11 non-exclusive factors:

1) The names given to the instruments, if any, evidencing the debt
2) The presence or absence of a fixed maturity date and schedule of payments
3) The presence or absence of a fixed rate of interest and interest payments
4) The source of repayments
5) The adequacy or inadequacy of capitalization
6) The identity of interest between the creditor and the stockholder
7) The security, if any, for the advances
8) The corporation's ability to obtain financing from outside lending institutions
9) The extent to which the advances were subordinated to the claims of outside creditors
10) The extent to which the advances were used to acquire capital assets
11) The presence or absence of a sinking fund to provide repayments

CA 6 stated in its opinion that none of these factors is controlling and that the facts and circumstances of each individual case determines how much weight to put on each factor.

Based on the facts considered, CA 6 reversed the Tax Court. It determined that eight of the factors favored a classification of debt and two factors were accorded little weight. The final factor weighing in favor of equity consisted of the lack of security, but the court ruled that this one factor did not outweigh all of the other factors pointing towards the existence of debt. Therefore, the shareholder advances were considered to be debt and the interest payments were deductible.

Although neither of these cases was a valuation case, the analyses that the courts provided give valuation analysts a road map of the items to consider when determining whether a stockholder loan on the books of a valuation subject is valid debt. I have seen many reports that do not even consider this type of analysis and either leave stockholder loans on the books as valid debt or treat them as non-operating loans (often resulting in an understated value that is not correct). However, in many cases, the principal amount has not changed in many years, no interest has ever been paid, and there are no loan agreements. These are only three of the factors that should be considered. The lists above that are referenced in the two appellate cases should be considered when analyzing a company's balance sheet to determine the validity and treatment of these loans.

[1] *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 [22 AFTER d2 5004] (3d Cir. 1968).

[2] *Indmar Products Co., Inc. v. Commissioner,* 05-1573 [97AFTR 2d ¶ 2006-73] (6th Cir. 2006).

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EXPERT TIP

Since the value of a company will differ depending on the classification of stockholder advances as debt versus equity and the swing in value can be staggering if the amounts are large, the issue can have large consequences in the valuation process.