PAUL R. HYDE
EA, MCBA, ASA, MAI

HYDE VALUATIONS, INC
Business, Real Estate, and Machinery & Equipment Appraisals
2662 ELMORE ROAD - P. O. BOX 9 | PARMA, IDAHO 83660-0009
(208) 674-7272 WWW.HYDEVALUATIONS.COM

APPRAISERS:
PAUL R. HYDE
BRIAN D. HYDE
JOSEPH PHELON

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Arm's Length Transactions

I recently was asked to review a business appraisal of an insurance agency done by a CPA for a divorce of one of the three shareholders. The agency has been in business for many years and is quite successful. The agency was purchased over thirty years ago by the father and father-in-law of the three shareholders (each of the three joined the firm over time) and a year or so ago, the shareholders bought out their father/father-in-law using the high end of a price to gross sales multiple based on an asset sale (seller keeps cash and receivables and pays off all debt), however they agreed to purchase the stock (keep the cash and receivables and assume all debt) at the same price despite there being over $1 million in long-term debt. The appraiser used only one appraisal method – the excess earnings method – and made a number of errors resulting in a value that unsurprisingly came in about the same price as the sale from father and father-in-law to the kids.

The following is the key question that arose from the previous appraisal: Was the sale from the father/father-in-law to the kids an arm's length transaction?

This same problem occurs in many appraisal situations – for example, a sale of a property from parents to kids, sale or gifts of interests in businesses, etc. The typical standards of value used for both business and real estate appraisals require that any transactions considered in arriving at the conclusion of value should be an arm's length transaction.

According to Shannon Pratt, a widely recognized business valuation authority, "one of the most useful but often overlooked market approach methods is analysis of past transactions involving the subject company."[1] In looking at past transactions, it is important to determine if the transactions were made on an arm's-length basis. If the transactions were made on an arm's-length basis, then they may be useful in determining an indication of value.[2]

Further, according to Pratt, the following are definitions of Arm's-Length transactions:[3]

> <u>Black's Law Dictionary</u>
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> Arm's length transaction. Said of a transaction negotiated by unrelated parties, each acting in his or her own self interest; the basis for a fair market value determination. A transaction in good faith in the ordinary course of business by parties with independent interests. … For example, if a corporation sells property to its sole shareholder for $10,000, in testing whether $10,000 is an "arm's length" price it must be ascertained for how much the corporation could have sold the property to a disinterested third party in a bargained transaction.

[1] Shannon P. Pratt, <u>The Market Approach to Valuing Businesses</u>. (New York: John Wiley & Sons, Inc., 2000), p. 42.
[2] Ibid, p. 43-44.
[3] Ibid, p. 42-43.

Barron's Dictionary of Finance and Investment Terms

Arm's Length Transaction. Transaction that is conducted as though the parties were unrelated, thus avoiding any semblance of conflict of interest. For example, under current law parents may rent real estate to their children and still claim business deductions such as depreciation as long as the parents charge their children what they would charge if someone who is not a relative were to rent the same property.

In reviewing the insurance agency prior transaction between the father/father-in-law and the kids, it was clear that the transaction was NOT an arm's length transaction. It was instead based on what the father/father-in-law wanted to ensure a retirement income and the kids went along. The definition of Fair Market Value requires that the value be that which a "hypothetical willing buyer and a hypothetical willing seller" would come to, neither under compulsion to buy or sell, and both parties having reasonable knowledge of relevant facts. I ended up doing a full appraisal of the interest in the insurance agency in order to determine its fair market value. It became clear that the formula used for the buy-out of the shareholders' father and father-in-law was not supported by the market data. Accordingly, it is not appropriate as an indication of value for the stock as it does not fall within the definition of fair market value. The prior sale was not an arm's-length transaction – it was done between family members with the desire to provide a retirement to the father and father-in-law of the remaining shareholders. An unrelated third party buyer of the stock would not have paid anything even close to the agreed upon price based on market data of other insurance agency transactions and the other business appraisal approaches.

It is important to recognize the parties and motivations involved in transactions when analyzing them as previous sales, or as comparable sales. Such information, while not always available, is necessary to determining the fair market value of businesses and real estate. Basing an opinion of market value on data that is skewed from not being at arm's length is a risk that appraiser's must try to overcome in situations where such transactions cannot be avoided. At such times additional analysis into the market, of competing businesses or real estate, and from parties involved in similar businesses or real estate is necessary.

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including livestock and machinery & equipment.**

Paul R. Hyde, EA, MCBA, ASA, MAI
Enrolled to Practice Before the IRS (Enrolled Agent)
Master Certified Business Appraiser
Accredited Senior Appraiser – Business Valuation & Real Property
Designated Member (MAI) - Appraisal Institute (Real Estate Appraiser)
Senior Appraiser – American Society of Agricultural
Appraisers (Machinery & Equipment and Livestock Appraiser)