

Valuation Issues in Shareholders' Agreements

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Many financial planning professionals have clients who own shares of a privately held company that is governed by a shareholders' agreement. Unfortunately, shareholders' agreements are frequently inadequately drafted in respect of establishing the basis by which the value or price of an equity interest in a company is to be determined, the specific circumstances giving rise to the need for a value determination, and in the value terms that are adopted. These deficiencies can result in unanticipated consequences, and costly and uncertain litigation when the parties involved disagree on the meanings or intentions of the agreement. This article addresses valuation issues that commonly arise in shareholders' agreements and how they can be addressed prior to the time the relevant provisions are enforced.

Where a company has two or more shareholders owning common (voting) shares, those persons often enter into an enforceable shareholders' agreement that sets out their collective intent as to their privileges, protections, and obligations as shareholders in the company. A properly structured shareholders' agreement serves the interests of both the minority shareholders and controlling shareholders, although typically it is more important from the standpoint of a minority shareholder. A minority shareholder is defined as one that holds 50% or less of the outstanding voting shares, and therefore cannot unilaterally control the affairs of the company.

Unfortunately, the valuation provisions of many shareholders' agreements are inadequate in one or more respects, including:

- failing to address possible eventualities that

give rise to the need for a valuation (so-called 'triggering events');

- inappropriately establishing the basis by which value or price is to be determined;
- failing to adequately define the value terms adopted in the agreement;
- relying on inappropriate shareholder exit strategies; and
- failing to protect shareholders where the company's shares are sold to a third party acquirer.

These and other deficiencies in a shareholders' agreement can have unintended consequences, and in some cases give rise to costly and uncertain litigation among the parties to a shareholders' agreement where one or more of the shareholders believes that he or she has been unfairly treated from a 'value' perspective.

Triggering events

Shareholders' agreements typically contain provisions that either permit or require the sale of individual shareholdings in various circumstances. It is important that parties to a shareholders' agreement understand and distinguish the various potential future events that might affect their shareholding interests. Where such eventualities are not addressed, they can give rise to uncertainty and consequences that affect all shareholders in the company. The 'triggering events' that normally should be considered for inclusion in a shareholders' agreement include the:

- death of a shareholder, including whether life insurance proceeds will be used to finance the acquisition of the deceased's interest, and how the adequacy of life insurance proceeds is to be established;
- permanent disability of a shareholder-employee, including how such disability is to be substantiated, and the treatment of disability premiums. It is also important to establish whether the disabled shareholder is granted the right or the obligation to sell his or her interest, or conversely whether the remaining shareholders have the right to buy the disabled shareholder's interest;
- retirement of a shareholder-employee, including whether retirement is mandatory a certain age, and if there are penalties for early retirement;



- termination of a shareholder's employment. The valuation provisions pertaining to termination are particularly sensitive given that a shareholder who perceives that he or she has been unfairly treated may claim oppression against the other shareholders or the company;
- marriage breakdown of a shareholder, which should take into account the provisions in the relevant provincial Family Law Act; and
- insolvency or bankruptcy of a shareholder, where again the valuation provisions must be carefully considered in light of bankruptcy laws that normally require a shareholder to receive 'fair market value' for his interest.

Properly structured, a shareholders' agreement can assure a shareholder who is terminating his or her association with the corporation that there will be a market for his or her shares at a price he or she and all other shareholders believe to be fair. It also provides continuing shareholders with control over outside parties becoming shareholders.

For each triggering event, the shareholders' agreement should set out how the transaction is to be effected (i.e. purchase of shares by the other shareholders, or by the company and subsequently cancelled), the method of determining the transaction price, and terms of payment.

The basis of determining of value

Shareholders' agreements sometimes specify how value or price is to be determined in various circumstances. The most common methods of establishing value are (1) agreement by the shareholders, (2) predetermined formula, (3) independent expert, (4) arbitration or mediation, or (5) a combination of the latter two where there is disagreement among experts.

As a general rule, the best approach is for the

shareholders periodically to agree upon the value(s) of specific shareholdings for various purposes, and to stipulate them in writing. Where this is done, it is important that the values be updated on a regular basis, usually annually following receipt of year-end financial statements. However, this approach often is impractical due to the difficulties in getting agreement among shareholders as to appropriate annual values.

Where valuation formulas are used, they often are based on some predetermined multiple of historical accounting earnings or book value. The use of predetermined formulas may result in inequities for several reasons. In particular, business values are influenced by changes to both internal and external factors, and any given formula does not reflect all such changes. For example:

- a multiple of some earnings measure (such as net income, net cash flows, earnings before interest and tax, and so on) for a particular year can result in wild distortions in determined value in the event that the company's financial performance was particularly good or bad during that year;
- using a multiple of an average earnings measure for several years to overcome annual fluctuations may not adequately reflect important business trends and recent changes; and
- a multiple of book value may not be reflective of the current value of a business' assets, which typically are measured on a historical basis, and does not incorporate 'goodwill' that the business has created (rather than acquired).

Where an independent expert is called on to determine value, either periodically or where a triggering event occurs, the parties to a shareholders' agreement should be satisfied that the person or firm selected is knowledgeable about

the nature of the business and that all relevant factors will be considered. A shareholders' agreement sometimes will name the specific firm that is to perform the valuation, or it may contain a list of suitable valuation firms from which the shareholders can agree to select when required. Often, the company's auditors are precluded from acting in the role of independent valuation experts due to their real or perceived conflicts of interest with one or more of the shareholders of the company.

Value agreed to by arbitration or mediation can be an expensive process, depending upon the availability of appeal from such a value determination. Further, it often is difficult for the different parties to reach a consensus regarding the selection of arbitrators or mediators, although in many cases a list of those acceptable is set out in the agreement.

Value terms in a shareholders' agreement

Shareholders' agreements often fail to adequately define the value terms adopted therein, leaving open the possibility of differences in interpretation that can materially affect the derived value of a particular equity interest. Even standard terms such as 'fair market value' or 'fair value' can have different meanings in various circumstances. Therefore, it is important that a shareholders' agreement clearly define what is meant by 'value' for each triggering event. In particular, the shareholders' agreement normally should address at least the following with respect to value:

- whether the 'en bloc' (i.e. as a whole) equity value of the company should be determined on an intrinsic (i.e. 'stand-alone') basis, or whether so-called 'special interest purchasers' should be taken into account. A special interest purchaser is one that believes it can realize post-acquisition synergies by combining the acquired company



with its existing operations, and therefore may be willing to pay a premium over the intrinsic value of a company. As a practical matter, in the absence of open market negotiations, the quantification of post-acquisition synergies is highly speculative, and intrinsic value normally is adopted as the appropriate value term;

- whether or not a minority discount should apply. A minority discount is a reduction from the pro-rata portion of en bloc fair market value that sometimes is applied to a minority interest given that a minority shareholder cannot unilaterally control the company. Shareholders' agreements normally specify that no minority discount will be applied;
- where the shares of the departing shareholder are to be acquired by the company, an assumption should be stated with respect to the source of funds. The en bloc value of the shares of a company (and consequently the pro-rata value of any interest therein) may be affected depending on whether a transaction is financed using funds within the company or from outside of the company; and
- where the acquisition of a deceased shareholder's interest is to be acquired using life insurance proceeds received by the company, the shareholders' agreement should clarify whether those proceeds are to be accounted for as a component of en bloc value. Where life insurance proceeds are excluded, the surviving shareholders may realize a benefit that would not have occurred in the absence of a shareholder's death.

For each triggering event, the shareholders' agreement should set out the terms of payment for the acquired shares. The definition of fair market value contemplates a cash-equivalent

transaction. Where payment is made over time, and market rates of interest are not paid on the outstanding balance, such factors normally should be considered in the determination of value.

Shareholder exit strategies

Unless stipulated otherwise in a shareholders' agreement or some other agreement among shareholders, the value of a minority interest in a privately held company frequently is worth less than its pro-rata portion of the en bloc value of the company. Furthermore, many third party acquirers are not interested in acquiring an interest in a privately held company unless they have control (i.e. majority ownership of the voting shares). Consequently, in the absence of an 'en bloc' sale of the shares of a privately held company to a third party acquirer, a minority shareholder seeking to divest of his or her interest normally is compelled to transact with the other shareholder(s). At the same time, the remaining shareholders in a private company typically want control over who can acquire an equity interest in the business. In circumstances where a specified triggering event does not apply, shareholders' agreements often rely on reciprocal buy-sell or 'shotgun' clauses to protect the liquidity of a shareholder's interests. Pursuant to a shotgun clause, a shareholder can offer to sell his or her shares to another shareholder at a price and on terms specified in the offer. The shareholder receiving the offer must either:

- accept the offer, and acquire the shares of the offering shareholder at the price per share and terms specified in the offer; or
- reject the offer, which requires the shareholder receiving the offer to sell his or her shares to the offering shareholder at the price per share and terms specified in the offer.

Whichever course of action is adopted by the shareholder receiving the offer, it results in a binding agreement of purchase and sale between the shareholders.

Issues may arise in a shotgun clause where the shareholders have materially different negotiating strength. This might include circumstances where one shareholder has access to greater financial resources, where the shareholders have different proportionate equity interests in the company, or where only one of the shareholders is actively involved in the business and is more knowledgeable about the operations and future prospects of the company. In some cases, particularly in small businesses, one shareholder may enjoy 'personal goodwill' – being the benefit that accrues to the business by virtue of the reputation, business contacts, and so on, of a particular shareholder, and which is not transferable. Accordingly, the business may be worth considerably more to a shareholder that has personal goodwill compared to a shareholder that does not.

To avoid the possible inequities of a shotgun clause while protecting both the shareholders who wish to divest of their interest as well as those remaining with the company, shareholders' agreements often include right of first refusal provisions. Right of first refusal provisions can be structured in one of two ways:

- as a 'hard' right of first refusal, whereby the shareholder wishing to sell solicits third party offers, and presents the best offer to the other shareholder(s) in the company. The other shareholder(s) are then given the opportunity to purchase the selling shareholder's interest based on the price and terms of that offer. If the other shareholder(s) elects not to purchase the shares within an agreed period of time, the selling shareholder can then sell his or her interest to the party making the offer on those same terms; or



- as a 'soft' right of first refusal, whereby the shareholder wishing to sell his or her interest establishes a price and terms of sale, which is presented to the shareholder(s) holding the right of first refusal. If the other shareholder(s) elects not to acquire the shares within an agreed time period, the selling shareholder is free to sell his or her interest in the open market at a price and on terms that are no less favourable than what was offered to the other shareholder(s).

The hard right of first refusal typically is preferable from the point of view of the person holding the refusal right. Third party purchasers rarely will spend a significant amount of time assessing a potential share acquisition in the face of an overriding right of first refusal. The soft right of first refusal typically is better from the vendor's perspective. Although it forces the prospective vendor to be disciplined when establishing the initial price and terms offered to the shareholder holding the first refusal right, in the event the offer is not accepted, the vendor is able to deal with third party purchasers unencumbered by a first refusal right.

Sale of shares to a third party

It often is beneficial for a shareholders' agreement to address circumstances involving the sale of the company's shares to a third party acquirer. In particular, it may be prudent for the shareholders' agreement to incorporate provisions dealing with (1) mandatory sale, (2) 'tagalong' rights, and (3) participation in a subsequent sale.

Many third party acquirers of privately-held company shares will close a transaction only if 100% share ownership is delivered. In such circumstances, the controlling shareholder (or group of minority shareholders who collectively control) will not want to have a transaction

thwarted by one or more minority shareholders that is not interested in selling his or her interest. Therefore, shareholders' agreements frequently provide that if a third party offer is received for all of the outstanding shares that is acceptable to a specified majority of shareholders, that all shareholders are obliged to tender to the offer on the same terms and conditions. These so-called 'drag-along' or 'mandatory sale' provisions protect the liquidity of a controlling shareholder or a group of shareholders that represent control.

At the same time, a shareholders' agreement should ensure minority shareholders the opportunity to sell into a third party offer at the same price and terms as accepted by the majority. These so-called 'coattail' or 'tagalong' provisions protect the liquidity of all shareholders in the event of such an offer.

Finally, in some cases where a departing shareholder disposes of his or her interest to other shareholders of the company, the shares of the company are subsequently sold to a third party acquirer 'en bloc' at a significant premium (on a per share basis). Consequently, the shareholders involved in the subsequent *en bloc* sale of shares may benefit significantly, partly at the expense of the shareholder who previously disposed of his or her interest in the company to the other existing shareholders. To alleviate the perceived unfairness of this situation, shareholders' agreements sometimes provide that during a specified time period after a departing shareholder disposes of his or her interest, that shareholder is entitled to participate in any gain on the *en bloc* sale of the company's shares (or net assets) to a third party. Such provisions can prevent one shareholder within a company from actively consolidating the interests of other shareholders with the intent of delivering the company *en bloc* to a third party acquirer, and profiting as a result.

Conclusions

It is incumbent upon persons entering into a shareholders' agreement to ensure that it adequately documents their collective intent with respect to the terms and conditions of the transactions it provides for, and that the value terms adopted in the agreement are carefully defined. As circumstances change over time, it is important to periodically review and modify, as necessary, the provisions of a shareholders' agreement prior to such time as it becomes the basis for an actual transaction. Financial planners can assist their clients who are shareholders in privately held companies by working with experts in the field of business valuation and shareholders' agreements to ensure that shareholders understand their various options, and that their collective intent is properly documented.

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