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Beyond Powel—Examining the Important Provisions of Operating Agreements and Shareholder Agreements

Panel Discussion

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VALUATION CONSIDERATIONS IN OWNERSHIP AGREEMENTS

Articles of incorporation, articles of organization, partnership agreements, shareholder agreements, and buy-sell agreements (collectively, "ownership agreements") often contain provisions designed to facilitate the transfer of ownership interests under specified circumstances. Such provisions typically define the terms under which the ownership interest of a departing shareholder, partner, or member is redeemed, or purchased, including describing how value—that is, the purchase price—will be determined.

Some ownership agreements' definition of value lacks the specificity required to address the circumstances that have the potential to exert significant impact on value, often resulting in extended, acrimonious, and costly litigation. Further, many ownership agreements lack a procedural process of determining value and determining value conflict resolution provisions. Therefore, a clear definition of value and a detailed process for determining the value in ownership agreements should be clearly drafted in operating agreements.

Valuation analysts can assist legal counsel in drafting the ownership agreement provisions regarding the valuation of the ownership interests. The analyst can inform on the profession's interpretation of the language of the proposed provisions and provide legal counsel the definitions that could be used in the ownership agreement. At the formation of the ownership agreement (or amendment/restatement), legal counsel may seek a valuation analyst's opinion of the value of certain ownership interests pursuant to the new language of the ownership agreement. That way, the stakeholders can better understand the value of the ownership interests as of a current date and how the process for the valuation is undertaken. If there are disagreements on the application of valuation methodology, the stakeholders may be able to resolve these issues with legal counsel before finalizing the ownership agreements.

The following sections outline important attributes of ownership agreement valuation provisions that will assist the valuation analyst in framing the overall ownership interest valuation analysis. These include (1) defining value and (2) defining the valuation process.

DEFINING VALUE

Salient factors to consider in defining "value" in ownership agreements include the following:

- State a clear definition of value within the selected mechanism of determining the price/value, which clearly states the following using conventional business valuation literature definitions:
    - The standard of value
        - e.g., fair market value as defined as "the amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts."[1]
    - The premise of value
        - e.g., value as a going-concern business enterprise
    - The level of value
        - e.g., noncontrolling, nonmarketable ownership interest level of value basis (i.e., value assuming a noncontrolling ownership interest in a nonpublic company)
- Identify the different value definitions that may apply given certain trigger events, such as: death, disability, voluntary termination, involuntary termination (or for cause), divorce, and retirement

[1] American Society of Appraisers, Business Valuation Standards – Definitions.

- Identify and consider other components to include or exclude under the definition of "value" in the ownership agreement that could affect the value conclusion
    - e.g., noncompete agreement, life insurance to fund the repurchase of shares, restrictions on transfer, requirement to maintain the entity structure (e.g., S status), right of first refusal, redemption versus purchase (e.g., anti-dilution provisions), structure of payment (e.g., ability to pay, personal guarantees), protecting confidentiality and trade secrets, dispute resolution procedures, drag-along rights, tag-along rights, earnings level calculations, and taxes (e.g., Section 754 elections)

See the first attachment titled "Defining "Value" in Ownership Agreements" for further detail and practical examples of operating agreement language.

DEFINING THE VALUATION PROCESS

Salient considerations with respect to drafting and defining the valuation process in ownership agreements, which may help to alleviate potential conflict and disagreement, include the following:

- Determine a mechanism/policy to determine the price of the to-be-transferred ownership interests that is agreed to by all owners (and all future owners, unless excluded), which include the following:
    - A fixed price
    - A price based on a formula
    - A price based on a specific valuation process
    - A valuation to be conducted by a qualified valuation analyst
- Identify an agreed upon avenue of selling the ownership interests:
    - Will the company make a market for the shares through tender offers, either regularly or from time to time?
    - Will there be a first right of refusal process?
    - Will family members or linear descendants of the current shareholder be exempt from requirements for non-related investors (i.e., an exemption for estate planning transfers)?

If there are any prior valuations that can guide the valuation analyst's understanding of the parties (i.e., a prior analysis as of or near the construction of the ownership agreement), future conflicts may be diminished given the agreed to examples of how value is determined pursuant to the ownership agreement.

See the second attachment titled "Guidance for the Third Analyst in a Three-Analyst Valuation Process" for further detail on typical valuation processes and conflict resolution considerations when involving multiple valuation opinions in determining the value of ownership interests.

Attachments:

[1] Scott R. Miller and Charles A. Wilhoite, "Defining "Value" in Ownership Agreements," *Insights*, Autumn 2015.

[2] Robert P. Schweihs, "Guidance for the Third Analyst in a Three-Analyst Valuation Process," *Insights*, Autumn 2016.

Defining "Value" in Ownership Agreements

Scott R. Miller and Charles A. Wilhoite, CPA

Articles of incorporation, articles of organization, and partnership agreements often contain provisions designed to facilitate the transfer of ownership interests under specified circumstances. Such provisions typically define the terms under which the ownership interest of a departing shareholder, member, or partner is redeemed, or purchased, including describing how value—that is, the purchase price—will be determined. Unfortunately, the definition of value provided in many corporate documents lacks the specificity required to address the circumstances that have the potential to exert significant impact on value, often resulting in extended, acrimonious, and expensive litigation. Therefore, a clear definition of value in ownership agreements is important.

Introduction

Ownership agreements are an important tool used to define a closely held business owners' rights and obligations, and ultimately to protect the interests of the owners. Ownership agreements may take many forms, including the following:

1. Bylaws
2. Buy-sell agreements
3. Shareholder agreements
4. Operating agreements
5. Partnership agreements.

In this discussion, we will use the term "ownership agreement" to refer to any type of ownership agreement that regulates the transfer or sale of ownership interests.

When drafting an ownership agreement, owners may incorporate one of any number of mechanisms for the purpose of determining price. These mechanisms include the following:

1. A fixed price
2. A price based on a formula
3. A price based on a specific valuation process
4. A valuation to be conducted by a qualified valuation analyst

However, owners often overlook the specifics concerning the definition of "value" to be applied in each of these scenarios.

Many ownership agreements do not provide a specific definition of "value," leaving the concept open to disagreement due to the resulting ambiguity. Instead, some ownership agreements use vague terms such as "market value" or "appraised value" to represent the price at which a selling owner will be redeemed.

When "value" is not clearly defined in an ownership agreement, the result is often a dispute between the terminating, or selling, owner and the continuing owner(s). In some cases this may lead to an extended litigation process. This is one reason why it is helpful to clearly define "value" as it pertains to the price at which an owner's interest will be redeemed at the time of a triggering event.

The definition attributed to "value" has the potential to positively affect either the selling owner or the remaining owner(s), when in fact value is generally intended to result in a "fair" economic transfer to all parties.

For example, a selling owner who owns less than a controlling interest may benefit if "value" is defined as the selling owner's pro rata share in the enterprise value of the business, without any discounts for lack of control or for lack of marketability.

Alternatively, the remaining owner(s) may benefit if the definition of "value" requires the inclusion of a lack of control and lack of marketability discount when such considerations were never initially contemplated.

At the time an ownership agreement is drafted, owners, to their detriment, may (1) not consider the impact that different definitions of "value" can exert on price or (2) hope that the definition of "value" relied on will benefit them.

However, an owner's exit scenario—often contemplated to occur decades beyond the entity formation date—rarely is considered fully at the onset of a venture. Therefore, it is in the best interest of all owners to clearly define their intent in an ownership agreement, rather than assuming, or hoping for, the best.

This discussion will:

1. provide common "value" definitions, including the standard, premise, and level of value;
2. identify and address additional, relevant considerations when defining "value," including intent and historical precedent; and
3. provide excerpts from ownership that define "value" in different ways.

Defining "Value"

Value can be, and is, defined in a number of ways in ownership agreements. Three important concepts that must be addressed in order to appropriately and clearly define value are:

1. the standard of value,
2. the premise of value, and
3. the level of value.

Standard of Value

The standard of value is the type of value being sought. The standard of value is specific to the ownership interest, the buyer and seller, and the context in which the ownership interest is being valued. The standard of value influences, and sometimes compels, the approaches and methods used by a valuation analyst to value an entity.

Common standards of value include the following:

- Fair market value
- Investment value
- Intrinsic value
- Fair value (in the context of state legal matters)

Fair market value is defined as "the amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts."[1]

Fair market value generally is understood to represent consideration on a "cash-equivalent" basis.

Investment value is defined as "the specific value of goods or services to a particular investor (or class of investors) based on individual investment requirements. . . ."[2]

Investment value may differ from fair market value (from the perspective of a particular owner) for the following reasons:

1. Differences in estimates of future earning power
2. Differences in perception of the degree of risk and the required rate of return
3. Differences in financing costs and tax status
4. Synergies with other operations owned or controlled

Intrinsic or "fundamental" value is defined as "an analytical judgment of value based on the perceived characteristics inherent in the investment, not tempered by characteristics peculiar to any one investor, but rather, tempered by how these perceived characteristics are interpreted by one analyst versus another."[3]

Intrinsic value is considered to represent the "true" or "real" worth of an item based on an objective evaluation of available facts.

Fair value (in states that have adopted the Uniform Business Corporation Act) is often defined as "the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable."[4]

Fair value in terms of business valuation (and not necessarily financial reporting) is usually a legally created standard of value that applies to certain specific transactions.

In most states, fair value is the statutory standard of value applicable in cases of dissenting stockholder appraisal rights.

Premise of Value

The premise of value reflects the actual set of hypothetical transactional circumstances applicable to an ownership interest. Much like the standard of value, the premise of value is specific to the ownership interest, the buyer and seller, and the context in which the ownership interest is being valued.

The premise of value may also influence the approaches and methods relied on by a valuation analyst to value an entity.

The premise of value can be classified in the following ways:

- Value as a going concern
- Value as an assemblage of assets
- Value as an orderly disposition
- Value as a forced liquidation

Value as a going concern is defined as "value in continued use, as a mass assemblage of income-producing assets, and as a going-concern business enterprise."[5]

The going-concern premise of value typically is used in business valuations where the subject company is expected to continue operating into the foreseeable future. The going-concern premise of value may be especially relevant to (1) entities with significant intangible value and (2) noncontrolling ownership interests with no ability to cause the sale or liquidation of assets.

Value as an assemblage of assets is defined as "value in place, as part of a mass assemblage of assets, but not in current use in the production of income, and not as a going-concern business enterprise."[6]

Value as an orderly disposition is defined as "value in exchange, on a piecemeal basis (not part of a mass-assemblage of assets), as part of an orderly disposition; this premise contemplates that all of the assets of the business enterprise will be sold individually, and that they will enjoy normal exposure to their appropriate secondary market."[7]

Value as a forced liquidation is defined as "value in exchange, on a piecemeal basis (not part of a mass assemblage of assets), as part of a forced liquidation; this premise contemplates that the assets of the business enterprise will be sold individually and that they will experience less than normal exposure to their appropriate secondary market."[8]

Level of Value

The level of value reflects characteristics of ownership, such as controlling versus noncontrolling ownership status, and the liquidity, or lack thereof, inherent in the ownership interest. Applicable valuation adjustments—for example, discounts or premiums—related to the level of value are ownership level adjustments that may apply to a specific ownership interest.

"Value" sections in ownership agreements should be clear regarding references to the permissibility or impermissibility of discounts or premiums related to the level of value for a specific ownership interest.

The level of value can be classified in the following ways:

- Synergistic level of value (i.e., value assuming a strategic buyer)
- Controlling level of value (i.e., value assuming a controlling buyer)
- Noncontrolling, marketable level of value (i.e., value assuming a noncontrolling ownership interest that is readily marketable or easily converted to cash)
- Noncontrolling, nonmarketable level of value (i.e., value assuming a noncontrolling ownership interest in a nonpublic company)

The level of value for an ownership interest subject to analysis may affect the methods an analyst relies on to value the subject company, as well as how the methods are applied. For example, an analyst typically would not consider a net asset value (e.g., liquidation-based) approach when the level of value for a particular ownership interest is defined as noncontrolling.

Similarly, an analyst may make adjustments to historical and projected earnings if the defined level of value for a particular ownership interest is controlling, and a hypothetical, controlling buyer would have the ability to cause such changes.

The level of value may influence the discounts and premiums applied to the subject ownership interest. Such discounts and premiums may be significant and may account for over 50 percent of the equity value in some scenarios.

Identifying the appropriate level of value can be confusing and challenging for owners, especially when there are varying rights among ownership interests and varying sizes of ownership interests. If the applicable level of value is not defined or described clearly in an ownership agreement, conflicts likely may arise between interested parties at the time of a triggering event or buy-out.

Intent and Historical Transactions

Relevant provisions of ownership agreements generally are understood to address the question regarding the "value" of ownership interests from the perspective of those forming/participating in the subject business. The initial formation of an entity typically contemplates the potential departure of owners prior to the expiration or dissolution of the entity.

Historical practice suggests that "value" typically is contemplated from an equity perspective (i.e., "fairness"). As the terms of an ownership agreement typically are negotiated and agreed upon by the parties covered by the agreement, it stands to reason that at least an attempt was made to incorporate terms that all parties believed were fair and reasonable at the time the agreement was developed.

Valuation analysts typically address the question of owner "intent" based primarily on consideration of observable, historical practice with regard to the implementation of a particular ownership agreement. Clearly, legal interpretation may be warranted.

Generally accepted valuation practice (for example, Revenue Ruling 59-60 issued by the Internal Revenue Service) suggests consideration of historical transactions in a company's equity when estimating fair market value.

Timely, historical transactions in a company's equity—in circumstances determined to be arm's-length—provide relevant information that reasonably can be considered when estimating the value of the equity of a company for redemption purposes.

A history of transactions in the equity of an entity often serves to neutralize "value" terms within an ownership agreement if "value" was defined or established in an inconsistent manner.

Historical transactions may be a key consideration when examining the intent of owners regarding the definition of "value" included in an ownership agreement. The analysis of historical transactions can provide insights with regard to owner intent relating to "value."

Further, historical transactions may also influence court decisions when there is a dispute over the applicable definition of "value."

For example, in *Estate of Maurice F. Frink v. Flowerama of America, Inc.*,[9] the estate argued that fair market value should be used as the relevant standard of value. The company argued that accounting book value was the applicable standard of value because it was defined in the subject ownership agreement as such.

In its decision, the court noted that **past redemptions** were made at book value and ultimately decided in favor of using book value as the price at which the estate was redeemed.

Past transactions, occurring at arm's length, allow disputing owners, or a court, to objectively analyze what definition of "value" may be most appropriate in a certain circumstance.

If prior arm's-length transactions have occurred under a certain standard, premise, and level of value, this adds validity to an owner's claim that such definition of "value" is unbiased and relevant to apply in an ownership redemption occurring under similar circumstances.

Examples of "Value" Definitions in Actual Ownership Agreements

This section presents examples of different definitions of "value" included in actual ownership agreements.

Example 1

> The option will be exercisable for an amount ("option price") equal to the product of (1) the **fair market value** of the company as a **going concern** taking into account the company's assets and the then-outstanding obligations of the company, including any unpaid balance of the preformation indebtedness, on the date of the triggering event; (2) the decimal equivalent of the percentage interest represented by the interest subject to option; and (3) the decimal equivalent of 60%. The 60% factor in the foregoing formula is intended to subject the product determined under clauses (1) and (2) to a 40% **discount to take into account a reasonable discount for lack of marketability and for noncontrolling ownership interest**. This 40% discount has been arrived at through arm's-length negotiation among the parties and, accordingly, is and will be deemed fair and reasonable under the circumstances.

This ownership agreement excerpt specifies "value" from three perspectives. The standard of value is clearly defined as "fair market value." The premise of value is clearly defined as "going concern."

Additionally, this agreement clearly states that the level of value will be noncontrolling and

nonmarketable. The agreement even goes so far as to define the exact level of discounts for lack of control and for lack of marketability considerations, in theory removing the decision from the hands of potential disputing parties and their valuation analysts.

The unique aspect of this ownership agreement is the predetermination of a level of discount to apply to the subject ownership interest. This tactic aims to remove some of the ambiguity, and, therefore, potential conflict between buyer and seller, regarding the appropriate level of combined discounts for lack of marketability and for lack of control.

Although the subject ownership agreement clearly states the definition of "value" based on the three key considerations previously discussed (i.e., the standard of value, premise of value, and level of value), room still exists for potential disagreement.

The company (i.e., the buyer) may argue that "fair market value" should be determined from the perspective of a noncontrolling owner prior to the application of the predetermined 40 percent discount.

This could include incorporating a noncontrolling level cash flow in the income approach and discounts to any market multiples derived from the analysis of controlling-interest transactions for the purpose of completing the market approach (i.e., the guideline transactions method).

The party exercising the option (i.e., the selling owner) may argue that "fair market value" should be determined from the perspective of a controlling owner. This could include incorporating a higher level of cash flow from the perspective of a controlling owner in the income approach and the application of premiums to market multiples derived from the analysis of noncontrolling, publicly traded interests for the purpose of completing the market approach (i.e., the guideline publicly traded company method). The justification being that a discount for lack of control is warranted only to the extent that a corollary control premium is incorporated in the initial fair market value conclusion.

The validity of each of these arguments may increase or decrease depending on the (1) size of the ownership interest subject to option or (2) rights and benefits inherent in the ownership interest subject to option.

If the size of the ownership interest subject to option approaches 50 percent, or if the subject ownership interest affords the owner significant attributes of control, an argument could be made for a control level of value (prior to the predetermined 40 percent discount).

If the selling owner is indeed a noncontrolling owner by all accounts (i.e., unable to exert any influence on the operations of the subject company), an argument could still be made that an excessive level of discount for lack of control has been incorporated in the option price based on (1) a claim that the pre-discounted fair market value inappropriately excludes any level of control premium, and (2) the basis for, and form of, the predetermined 40 percent combined discount (i.e., such a discount may be relevant and reasonable at a point in time, but nor over all time, particularly as it relates to the portions allocable to lack of control and lack of marketability).

The subject ownership agreement goes on to read as follows:

> In any case in which the company acting through the board of directors and the optionor (each a "party") are unable to agree upon the fair market value of the company as a going concern (taking into account the company's assets and then then-outstanding obligations of the company, including any unpaid balance of the preformation indebtedness) within the 30-day period for such agreement under Section 2.6(b), each shall give a notice to the other appointing an appraiser.

Although this agreement goes to great lengths to define "value," ultimately there may be a significant divide between different valuation analyst's interpretations of "fair market value" given the circumstance of a mandatory 40 percent discount.

Example 2

> The value of the affected shareholder's ownership interests will be determined by multiplying the shareholder's percentage ownership interest by the fair market value of the company (**the amount that could reasonably be expected to be realized upon sale**) net of liabilities of all company assets, with appropriate discount for a noncontrolling interest or lack of marketability. Provided, however, in the event the triggering event is the death of a shareholder as provided in Section 9.6 above, the value of the deceased shareholder's ownership interest will **not include any discount for a noncontrolling interest or lack of marketability**.
>
> The fair market value of the company assets will be determined by agreement between a majority in interest of the

remaining shareholders holding all shares (voting and nonvoting) and the affected shareholder or the affected shareholder's successor. In the event an agreement as to the value cannot be obtained, the fair market value of the company's assets will be determined by a valuation. The company will first select a valuation analyst who will value the company's assets.

The affected shareholder or the affected shareholder's successor may elect, either before or after the company has submitted a report, to select another valuation analyst.

In the event the two appraisers fail to reach agreement on the fair market value of the company's assets, the two valuation analysts will mutually select a third appraiser whose determination of the value of the company's assets will be binding on the company and the affected shareholder or the affected shareholder's successor.

The subject ownership agreement excerpt defines the standard of value as the "fair market value of the company." The subject ownership agreement goes on to clarify the specific basis for establishing fair market value as "the amount that could reasonably be expected to be realized upon sale" (of the entire company).

The subject ownership agreement also specifies when discounts for lack of control and lack of marketability should be considered, and when such discounts should be ignored.

This ownership agreement is unique in that the level of value differs based not on the size or attributes of the subject ownership interest, but rather on the circumstance under which the owner withdraws (i.e., voluntarily versus upon death).

Although the standard of value is clearly defined, the ownership agreement leaves some ambiguity with regard to the premise of value. The subject ownership agreement states that the fair market value of the company is "the amount that could reasonably be expected to be realized upon sale." It is not clear whether the hypothetical sale would reflect:

1. value as a going concern or
2. value in liquidation (if appropriate).

If the company's net asset value exceeds its value as a going concern, a legitimate question may arise regarding the appropriate premise of value to consider. The subject ownership agreement states the fair market value of the company, not the subject interest, is the starting point for the determination of "value."

However, if the subject interest is a noncontrolling ownership interest, then is the "value" of the individual assets relevant? If so, is the "reasonable sale price" based on forced liquidation, or should the "reasonable sale price" reflect an orderly disposition?

Qualifying the level of value to be used based on the nature of the triggering event may also lead to disagreement between the selling owner and the remaining owner(s). If a sale is triggered due to disability or another unavoidable event, should a discount for lack of control and a discount for lack of marketability still be applied?

Example 3

The definition of "value" incorporated in an ownership agreement may be used as a tool—advertently or inadvertently— to:

1. benefit the seller of an ownership interest (i.e., no allowable discounts),
2. benefit the buyer of an ownership interest (i.e., mandatory discounts), or
3. discourage the sale or transfer of ownership interests.

The following excerpt from an ownership agreement illustrates how the definition of "value" can be used to discourage certain types of transfers and benefit the remaining owner(s) (i.e., buyers).

In the event any shareholder's shares are involuntarily transferred to any nonshareholder person or entity, without written consent of the other shareholders of the corporation, the transferee will be obligated to sell, and the corporation will have the right to purchase, all or a portion of the involuntary transferred shares. This provision will not apply to a transfer by a shareholder to a revocable trust controlled by the shareholder, nor a transfer by operation of law on the shareholder's death.

Under this paragraph, the purchase price will be determined by the following formula:

- The value of the assets of the corporation will be determined at **book value, without any weight given to going-concern value or goodwill, and taking into consideration any accumulated depreciation** ("asset value").

- The total amount of current and long-term liabilities will then be deducted from the asset value, resulting in a "net asset value."
- Net asset value will then be **reduced by 50%**, and from this figure, the pro rata value of the involuntarily transferred shares ("purchase price") will be determined.

In this example, the formula for determining "value" is defined. It is also clear that the definition of "value" as described in this example is used as a tool to discourage involuntary transfers of ownership interests.

There have been multiple court cases that have supported the use of book value to determine a purchase price, even if that value differs significantly from the fair value or fair market value of the subject ownership interest.

One deciding factor in these court cases was that the definition of "value" is clearly defined in the subject ownership agreement as book value.

This was the case in (1) *Estate of Maurice F. Frink v. Flowerama of America, Inc.*;[10] (2) *Tynes E. Mixon, III, M.D., v. Iberia Surgical LLC*;[11] and (3) *Estate of Cohen v. Booth Computers and James S. Cohen*.[12] In each of these court cases, the court upheld that book value was the appropriate definition of "value" to use in determining price, even though the resulting price was significantly lower than if calculated on a fair market value basis.

In each of these cases, the court cited a clearly defined standard of value (book value) in the subject ownership agreement as a reason for its decision.

Example 3 and the court cases cited above illustrate how defining "value" can be used by founding owners to serve a specific interest that otherwise may not be appropriate or defensible under generally accepted valuation practices.

Conclusions

Founding owners of an entity are free to define "value" in any legal manner desired. The definition of "value" incorporated in an ownership agreement, if not appropriately considered and structured, may inadvertently benefit the seller of an ownership interest to the detriment of the buyer, or inadvertently benefit the buyer of an ownership interest to the detriment of the seller.

As noted in example 3, the founding owners of an entity may even use the definition of "value" to discourage or encourage certain types of sales.

The definition of "value" incorporated in an ownership agreement should reflect the long-term intent of the founding owners. However, the founding owners drafting the ownership agreement may consider the likelihood that they ultimately may leave and new owners may join.

Founding owners should also keep in mind that unless specifically defined, the term "fair market value," when left to qualified valuation analysts, will be estimated based on consideration of generally accepted valuation practice, as influenced by the facts and circumstances unique to the transaction under consideration.

"The definition of 'value' incorporated in an ownership agreement, . . . may inadvertently benefit the seller of an ownership interest to the detriment of the buyer, or inadvertently benefit the buyer of an ownership interest to the detriment of the seller."

In order for owners to maintain control over transactions and realize their intent, it is important that an ownership agreement clearly defines "value" in all key respects, including:

1. the standard of value,
2. the premise of value, and
3. the level of value.

Further, clarity in an ownership agreement may be enhanced if it gives illustrative examples regarding how the definition of "value" is intended to be applied.

As presented in examples 1 and 2, even when the definition of "value" is well thought out and defined, there is still room for interpretation, and, therefore, potential dispute.

As external (e.g., economic and industry) and internal (e.g., aging owners and changing employees) circumstances evolve and change, the need for potential modifications to definitions and interpretations of "value" may develop, regardless of diligence and thought incorporated in an original ownership agreement.

Dissenting owners can argue the intent, or original definition of "value" incorporated in an ownership agreement, is no longer relevant or fair based on a change in circumstances.

One useful method to minimize the potential for conflict relating to the buyout provision in

an ownership agreement is to engage a qualified, independent advisory team—represented by a valuation analyst and legal counsel—to analyze owner intent and complete a valuation based on a clearly stated definition of "value."

Completing such a process prior to the development of an ownership agreement (or redemption) may provide valuable information for the parties that should better enable them to reflect their intentions in the agreement and adhere to consistent redemption practices after the consummation of the agreement.

By preemptively performing a valuation, the owners and interested parties can provide input prior to conflicts of interest clouding the debate. The valuation process can then be repeated in a consistent manner at defined intervals, minimizing the potential for dispute at the time a triggering event occurs.

Notes:

1. American Society of Appraisers, Business Valuation Standards – Definitions.
2. *The Appraisal of Real Estate*, 11th ed. (Chicago: Appraisal Institute, 1996), 638.
3. Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business*, 4th ed. (New York: McGraw-Hill, 2000), 31.
4. Model Business Corporation Act § 13.01(3)(ABA 1984).
5. Pratt, Reilly, and Schweihs, *Valuing a Business*, 33.
6. Ibid.
7. Ibid.
8. Ibid.
9. Estate of Maurice F. Frink v. Regions Bank, et al., 725 N.W.2d 658 (Iowa Ct. App. 2006).
10. Ibid.
11. Mixon v. Iberia Surgical, L.L.C., 956 So.2d 76 (La. Ct. App. 2007).
12. Estate of Cohen, ex. rel. Perelman v. Booth Computers, 22 A.3d 991 (N.J. Super. Ct. App. Div. 2011).

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Entity-Level vs. Ownership-Level

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As a result, in a fair value context for a dissenter case, it may be necessary to identify whether including or excluding a conglomerate discount is likely to unjustly benefit one party or the other. Ideally, the ultimate value impact on all parties should be equitable.

Conclusion

The fair value standard in a dissenter case often presents a number of valuation considerations specific to the engagement that are not necessarily present in a "standard" valuation engagement.

First, it is important to understand the relevant state statute and court precedents that may affect the current engagement.

Second, it may be necessary to recognize potential valuation adjustments as entity-level or ownership-level adjustments, and then identify whether the inclusion of an adjustment is appropriate based on the applicable fair value definition and the facts and circumstances of the particular engagement.

Third, it is important to understand that certain entity-level discounts may be appropriate under a fair value standard and to properly apply the necessary methods to quantify a reasonable valuation adjustment.

Finally, consideration may be given to analysis of the concluded results from both a dissenting shareholder and a nondissenting shareholder perspective in order to establish the reasonableness of economic returns afforded to both parties.

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Guidance for the Third Analyst in a Three-Analyst Valuation Process

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Both shareholder contracts and shareholder controversies often call for three valuation analysts to participate in the ownership transition valuation of the subject business, business ownership interest, or security. Private company security buy/sell agreements often use this three-analyst process. And, disputing parties in shareholder oppression, dissenting shareholder appraisal rights, and other breach of fiduciary duty controversies often turn to the three-analyst valuation process in order to resolve their differences. How the three-analyst process works in each situation is determined by either the shareholder (or other) contract or the agreement of the parties. This discussion recommends guidelines both to valuation analysts—and to other process participants—involved in a three-analyst business/security valuation process.

Introduction

In many closely held businesses, the owners want to personally know all of the other shareholders.[1] For the closely held company shares to transfer in an orderly fashion, the owners may insist that all owners subscribe to an ownership agreement, such as a shareholder agreement.

Such an agreement may have a redemption clause which allows for share purchases to be made only by the company or by the other current owners—and only at the price derived from a contractual valuation process.

The valuation provisions in shareholder agreements typically provide for shareholder liquidity by providing:

1. a market for the shares and
2. a mechanism for the purchase of and payment for the shares.

The current shareholders may want to know that the shares will stay in friendly hands in the event of another shareholder's termination of employment, retirement, physical or mental disability, or death.

The shareholder agreement will also typically address the ownership of the shares in case of involuntary transfers due to another shareholder's divorce, bankruptcy, insolvency, or legal disability.

The valuation process can include various adjustments to account for particular attributes or circumstances that the individual shareholders face. For example, the individual shareholder usually does not have the unilateral right to influence or control the management and operations of the subject company.

Therefore, the valuation process can include various adjustments to account for an individual shareholder's lack of ownership control.

Sometimes the prescribed valuation process requires the application of a valuation pricing formula.

To be respected by interested parties (including, for example, the Internal Revenue Service), the valuation pricing formula should be clear, unambiguous, and bear some resemblance to the fair market value of the shares particularly at the time the valuation pricing formula is established.

It may also be important that the valuation pricing formula result in the fair market value of the

shares as of time of the event (occurring sometime in the future) that triggers the application of the formula.

Disadvantages of Relying on a Valuation Pricing Formula

It is unusual for any one formula that was selected at one point in time to consistently provide reasonable and realistic valuations at all other points in time. Dislocations can occur.

Typically, a formula is not very flexible. After all, it's supposed to be "fixed" and unambiguous. A formula may not be flexible enough to take into account changes in, for example, the following factors:

1. The company's prospects
2. Industry in which the company operates
3. Current economic environment
4. Prevailing accounting conventions

If the triggering event occurs when the company is affected by a temporary upturn or downturn, the valuation pricing formula could be viewed to be unfair.

Businesses change due to nonrecurring events such as the introduction of a new product line. Before the introduction of a new product, reported earnings may be abnormally low because they reflect one-time research and development expenses to create the new product and marketing expenses associated with the launch.

After the new product is successfully launched, the early positive earnings may be low. This is because they do not yet reflect the normal, longer-term expected earning power of the new product.

Conversely, the currently reported earnings of the business could be higher than they are expected to be in the future because demand for a significant product has declined or because of a delay in the performance of a significant customer contract.

Industries change when, for example, regulatory restrictions are temporarily added or eliminated. Competitors can make impulsive decisions that have only a short-term impact on the earnings or assets of the subject business.

It is not unusual for a valuation pricing formula to fix the multiple of earnings or the multiple of book value despite any changes in the external economic environment. The economic environment in which the company operates is always changing both locally and nationally.

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Events that affect the economic environment that are entirely external to the business can have an important impact on the value of a business. The effect of those external events may not be captured in the typical valuation formula.

Net asset value (or net book value) isn't supposed to be controversial but it often is. Accounting rules can change or the business may adopt an alternative but acceptable accounting convention after the valuation formula was established. This procedure could cause a dislocation to the share value under the valuation formula.

For example, the company may voluntarily or involuntarily change its policy regarding contract revenue recognition, last-in, first-out (LIFO) or first-in, first-out (FIFO) inventory valuation, capital investment capitalization, or categorization of leases as operating or capital.

All parties may not always accept a value derived from a formula (e.g., the Internal Revenue Service may not be required to accept it if it is judged to be a testamentary device). If a transaction takes place for any purpose at a price different from the formula, the integrity of the formula may be jeopardized.

Earnings of the business may be volatile. Some formulas try to accommodate for that volatility by, for instance, using a strait average or a weighted average of the trailing three years of earnings.

In some situations, the formula valuation calculation is made only once per year as of a specific date and the price is supposed to prevail until a new value is calculated the following year. In other situations, the formula valuation calculation is made quarterly or even daily.

The company may not have enough money on hand to be available to redeem the shares at the formula price. The company (or another shareholder, for instance) who has the opportunity or the obligation to redeem the shares may not have the cash available (or the proceeds from a life insurance policy) to satisfy the obligation.

To overcome these disadvantages, rather than relying on a valuation pricing formula, many

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shareholder agreements call for a valuation pricing process.

The Valuation Pricing Process

A common valuation pricing process requires the company to establish a price at which it intends to redeem the subject shares. That price may be the result of the application of a valuation pricing formula.

If the shareholder rejects the company's offer price, it is common for the next step in the valuation process to require that each of the parties retain its own valuation analyst.

The valuation process should outline each analyst's assignment. There are several possible assignments, as follows:

1. Each analyst reaches an independent opinion of value and issues an opinion report to his or her client. If the two values are close, say within 10 percent of one another, the average value is the price at which the redemption transaction takes place.
2. The two analysts work together to reach one opinion of value which establishes the transaction price.
3. Without rendering an opinion of value, the two analysts agree on a third analyst to conduct one independent opinion which establishes the transaction price.
4. After rendering opinions that are too far apart (say, beyond 10 percent), the two analysts agree on the name of a third analyst.

The Valuation Target

When the two parties expect the decision maker (the judge) to split the opinions of each of the two parties or weight them somehow, it is more likely that the parties will adopt extreme positions and encourage their analyst to follow their valuation target. We often see that in marital dissolution cases, for example.

However, if the two parties anticipate that the judge will not split the difference but instead will choose only one of the two valuations, then each party will be more likely to encourage a less extreme valuation target. This is the theory behind what is known as baseball arbitration.

But, baseball arbitration only creates the right set of incentives for the parties when both parties would always be better off by submitting a more honest, less biased valuation than a more aggressive one.

Baseball arbitration works well in situations when, after the negotiation, the two parties will continue to have a relationship with each other (as in a labor dispute or when the parties are slicing a whole pie) because the downside of taking an aggressive position that is found to be unsuccessful by one of the parties is great.

Even if an aggressive position was found to be successful, in a marital dissolution for example, the subsequent grudge will impute a cost on the future relationship between the two parties.

Using the marital dissolution situation as an example, the parties are dividing one pie (the collection of marital assets), but they may share responsibility for raising their children, and the cost of causing greater deterioration of the future relationship could be great.

Baseball arbitration may not work well in situations where:

- a party believes that the decision maker is likely to make an error;
- one of the parties can achieve an outsized positive result without the same risk of a downside result (due to having a relatively small ownership percentage or some other kind of financial leverage, for instance); or
- there is no expectation of an ongoing relationship between the parties.

When one or both of the parties is encouraged to take an aggressive position, a third analyst is often required to effectuate a transaction that has been triggered by the provisions of a buy-sell agreement.

The third analyst's assignment is to:

1. select one of the party's opinion or the other (baseball arbitration);
2. develop his or her own independent opinion, which will prevail; or
3. develop his or her own independent opinion, which is averaged with the closer of the

other two opinions of value—this penalizes the outlier valuation target.

The Third Analyst's Assignment

Most shareholder agreements do not completely describe the third analyst's assignment so the components of the third analyst's assignment should be carefully defined, regardless of the written shareholder agreement.

The most obvious reasons for clearly defining the assignment is for all parties to know who is responsible for providing the following:

- Professional services to execute the assignment and to whom that person reports
- Information that is required to execute the engagement and with whom that information may be shared
- Payment for the services and the indemnification of the third analyst.

The third analyst may be engaged to execute any one of several different roles.

In the role of finder of fact, the third analyst reaches a value conclusion based on the evidence provided by the valuation presented by each of the two parties as would a judge.

As mediator, the third analyst's role is to reconcile the opinions of others and to assist the parties is reaching an agreement. The mediator educates the parties and offers options that may resolve the differences.

When the third analyst is engaged to render an independent opinion, the third analyst should make sure the parties are aware of the third analyst's instructions so that the parties to the valuation pricing process will respect the results.

Instructions for the third Analyst

Many people hold the mistaken notion that there can be only one "value." Instead, those familiar with the valuation profession are aware that there are many factors that influence the value conclusion.

The first influential factor is the applicable definition of value. The purpose of the valuation usually determines the appropriate definition of value.

Identifying and clearly defining the purpose and objective of the business valuation assignment goes a long way towards eliminating many of the problems that occur with the conclusions of business valuation projects.

While it seems simple, and should be simple to understand, failure to clearly define the elements of the valuation assignment at the outset of the business valuation assignment is one of the greatest sources of errors, delays, excess costs, and misunderstandings between client and analyst in a business valuation.

It may seem obvious that the first step is to define the task. However, when asked to participate in finding a solution to a client's problem, the client often does not know how to define the valuation assignment, and communication to agree on and mutually understand the assignment is often an important step.

In fact, valuation assignments that have turned out poorly are often due to a failure to carefully define the assignment at the outset.

The components of a well-defined third analyst (or almost any other business valuation) assignment include the following:

- Objective
- Purpose
- Property subject to value
- Definition and premise of value (contract, state law)
- Applicability of discrete valuation discounts, including key person dependence
- Valuation date
- Valuation approaches and methods
- Work product

In a third analyst process, the objective of the valuation assignment should be made clear and in writing. The typical objective for the third analyst is to provide his or her professional opinion of the value of the shares that are subject to redemption as of the valuation date.

The shares subject to redemption usually represent a noncontrolling, nonmarketable equity interest that is to be redeemed under the terms of the buy-sell agreement.

It is not always appropriate, however, for the third analyst to apply discounts from the pro rata value of the shares to reflect the shareholder's lack of control and lack of marketability.

Different statutory, regulatory, and case precedent standards govern valuations of businesses and business interests under various jurisdictions for diverse purposes. Many business valuations fail to reach a number representing the appropriate definition of value because the analyst failed to match the valuation methods to the purpose for which the assignment was being performed.

The result of a particular valuation can also be inappropriate if the client attempts to use the valuation conclusion for some purpose other than the intended one.

Valuation reports typically contain a set of limiting conditions and one of the typical limiting conditions is as follows:

> This valuation is valid only for the valuation date or dates specified herein and only for the valuation purpose or purposes specified herein. No other purpose is intended or should be inferred.

Much of the litigation involving business valuation arises because the parties have failed to match the valuation methods to the assignment's intended purpose.

The purpose of the valuation encompasses the use to which the valuation exercise is expected to be put. A valuation conclusion prepared for one purpose may not be the appropriate valuation conclusion for another purpose.

The purpose of the valuation often determines the applicable standard of value—that is, the definition of value being sought—and almost always influences it.

The date, or dates, at which the business is being valued is critically important because circumstances can cause values to vary materially from one date to another, and the valuation date directly influences data available for the valuation.

Every day, observers of the public stock markets see sudden and substantial changes in the value of a particular company's stock.

In many court cases, especially those involving tax litigation, significant changes in value over very short time spans have been justified because of changes in relevant circumstances.[2]

Many internal and external factors can cause changes in the value of an interest in a company. Obviously, a sudden change in a company's earnings, especially if unanticipated, can have a substantial effect on value.

Also, the value of a business interest varies with the cost of capital, a factor over which individual businesses have little control. Major events, such as the signing or termination of a major customer contract, can also have a dramatic, immediate impact on value.

In most business valuations, the opinion of value will be based at least partly on other, similar transactions, such as the prices at which stocks in the same or a related industry are trading in the public market relative to their earnings, assets, dividends, or other relevant variables, if such data are available.

It is important to know the valuation date when using guideline companies in the valuation so that the guideline transaction data can be compiled as of the valuation date, or as near to it as is practically possible.

The valuation date is usually the date of the event that triggered the provisions of the buy-sell agreement which is often the date on which the shareholder's employment was terminated.

But there are other events that may have triggered the redemption of the subject equity investment such as oppression of the shareholder or dissent by the shareholder from actions taken by the company management.

Sometimes there is more than one valuation date. For example, in shareholder redemptions, the parties may not stipulate to the trigger date and the value as of more than one date many be needed in order to resolve the dispute.

When the choice of valuation date in such cases is a legal matter, as part of defining the assignment, the third analyst may be asked to consider all the potentially applicable valuation dates and be prepared to address the value as of each date.

Sometimes a court will give an advance ruling on the valuation date to avoid the expense of doing analyses as of dates that the court will not deem relevant.

Some of the most important sources of guidance as to the applicable standard and premises of value for the given situation are the following:

- Statutory law (state and federal)
- Case law (cases decided under the controlling statutory or common law)
- Administrative regulations (e.g., Internal Revenue Service revenue rulings)[3]
- Company documents (e.g., articles of incorporation or partnership, bylaws, meeting minutes, agreements)
- Contracts between the parties (e.g., buy-sell agreements, arbitration agreements)
- Precedent established by prior transactions
- Directives issued by the court (in some litigated cases where the standards or premises are not clear, the analyst may take the initiative to seek direction from the court regarding the relevant definition of value)
- Discussions with an attorney involved in the valuation matter or experienced in similar matters
- Legal case documents (e.g., complaint, response, and so forth)
- The analyst's experience and judgment

In certain situations, the third analyst's assignment may be limited to analyzing only a certain valuation method or only one component of the dispute between the parties.

For instance, the controversial matter that separates the parties may be the proper normalization adjustments to make when arriving at a component of the valuation pricing formula such as EBITDA[4] or book value.

It is also important that the form of the third analyst's work product be understood. The form of the work product ranges from an oral opinion of value to a simple letter to a full narrative opinion report including all supporting data and documentation.

Communication

For the valuation process to be respected, it's important for the third analyst's instructions regarding communication be understood.

The third analyst should be instructed regarding the confidentiality of the documents being produced, whether the parties will be producing documents separately, whether documents produced by one party are to be shared with the other party, whether either party is permitted to communicate orally or by electronic means with the third analyst outside of the presence of the other party, how will any required in-person site visits be attended, and the dissemination of the third analyst's work product.

Unlike the delivery of work product in the typical valuation assignment, in the case of the third analyst valuation process, the work product is usually not issued as an incomplete document that is subject to discussion.

The benefit of issuing incomplete work product for discussion purposes in the typical valuation assignment is to allow the audience to provide advice regarding the accuracy of the information upon which the analysis depends and to achieve a reasonable understanding of the analysis.

Instead, the work product of the third analyst is a complete, final opinion that is not subject to discussion.

There is no universally acceptable final work product format for the third analyst. The work product may be a full narrative opinion report prepared in a format consistent with that proscribed under (1) the Uniform Standards for Professional Appraisal Practice or (2) another set of agreed-upon business valuations standards.

The work product may be nothing more than a simple statement of conclusions. Or, the work product could follow any other format to which the client agrees.

The third analyst is entitled to indemnification. A typical indemnification provision states that the parties agree to indemnify and hold the third analyst harmless from, and will defend the third analyst

against costs or liabilities of any nature whatsoever which result from, claims against the third analyst where such claims arise out of any use of the results of the third analyst's work on this engagement.

The third analyst will provide independent valuation assistance only. The third analyst will not provide legal, accounting, or taxation advice.

The parties may want to develop some reasonable expectations regarding the timetable for the start and completion of the project and any important intermediate events.

Who will be responsible for paying the third analyst's fees and expenses should be clear. It is usually a good practice to reach an understanding and to establish reasonable expectations regarding the amount of the fees and expenses that will be incurred in performing the assignment as defined.

Typically there is no work required from the third analyst after rendering the final opinion. Therefore, the third analyst should expect to be paid before rendering that opinion.

Conclusion

The third analyst assignment may seem to be simple, but it is important for the parties who are engaging the third analyst to recognize the following:

1. The parties who are engaging the third analyst are already involved in a controversy.
2. Valuation problems are inherently controversial.
3. Value conclusions are usually not based on absolutely settled data and professional judgment is a prerequisite to solving the valuation problem.
4. The third analyst is taking directions and is not the director of the project.
5. Clients don't want the third analyst's fees to include a premium to account for the risk of valuation malpractice litigation.
6. For the indemnified third analyst, the scope of the valuation assignment can be narrowly focused on the controversial valuation issues.
7. For the unindemnified third analyst, the scope of the valuation assignment includes the time required to continuously challenge the integrity of the instructions given to other professionals, instructions given by other professionals, advice rendered by other professionals, and information provided by the client and other professionals.

   Analysts should refuse to accept third analyst assignments unless the parties provide adequate indemnification.
8. For the parties, the possibility that valuation malpractice may be alleged is disruptive to the entire professional team.
9. For both the plaintiff and the defendant in litigation alleging valuation malpractice, it is complicated, expensive, and there is a low probability of a satisfactory award.

Of course, parties to the third analyst valuation process do not want to be involved in subsequent litigation and neither does the third analyst. When the assignment is to provide the best, unbiased opinion, the third analyst should be indemnified from future litigation. The analyst doesn't control many of the circumstances that surround the resolution to the valuation controversy.

When both parties to the third analyst assignment provide indemnification, it does not mean that:

1. the third analyst is not independent,
2. the strength of the third analyst's opinion is weakened,
3. the third analyst's opinion is tainted, or
4. the third analyst will not stand behind and defend the opinion.

Notes:

1. For convenience only, "shares" is used in this discussion to refer to the equity that is subject to a legal agreement to which the equity owners are committed. The equity may be shares in a corporation or units in a partnership or units limited liability company.
2. See, for example, Morris M. Messing, 48 T.C. 502 (1967), *acq*. 1968-1 C.B. 2. Even though the company made a public offering at over $36 shortly after a gift of stock, the court upheld a value of $13 for gift tax purposes as of the date of the gift.
3. Note that administrative rulings do not have the force of law, but represent the position of the agency administering the law as to their interpretation of the law and rules for applying it.
4. Earnings before interest, taxes, depreciation, and amortization.

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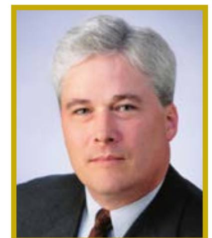

Weston C. Kirk Biography

Weston C. Kirk, CVA – Weston is a manager with Willamette Management Associates, a 50-year-old nationally prominent business valuation, forensic analysis, and transaction financial advisory services firm. He works with the firm's national and international clients from the Atlanta practice office. His practice includes business valuation, economic analysis, and financial opinion services. He predominately works with the firm's ultra-high-net-worth clients within our wealth management valuation services practice which includes gift, estate, and generation-skipping transfer tax matters.

For over seven years, Weston has been valuing ownership interests in companies, intangible assets, and other business interests for a variety of purposes, including transaction pricing and structuring; taxation planning and compliance (including federal income, gift, charitable gift, estate, and generation-skipping transfer tax); ESOP transaction and financing; tender offers; stock option offers; litigation; and strategic information and planning.

Weston has performed various types of valuation and economic analyses, including merger and acquisition valuations, fairness opinions, ESOP formation and adequate consideration analyses, business and stock valuations, litigation disputes and damages analyses, Internal Revenue Service audit rebuttals, undivided interests in real estate valuations, promissory note valuations, guaranty fee analyses, and gift and estate tax valuations.

He holds a B.B.A. in finance (with honors) from the Georgia State University ("GSU") J. Mack Robinson College of Business and a certificate in economics from the GSU Andrew Young School of Policy Studies.

Weston holds the certified valuation analyst designation of the National Association of Certified Valuators and Analysts. He is a non-CPA associate of the American Institute of Certified Public Accountants ("AICPA") and a member of the AICPA section on forensic and valuation services. Weston is also a member of the Association for Corporate Growth Atlanta.

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Willamette Management Associates

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