



PASSING THE TORCH: SHAREHOLDER TRANSITIONS

A Primer on Shareholder Transitions from a Valuation Perspective



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Passing the Torch: Shareholder Transitions

INTRODUCTION

- *Why this topic and why now?*
 - The global pandemic has caused many owners of privately held businesses to refocus
 - Businesses have been stress tested
 - Disruption also created space for more entrepreneurs
 - Pressure to identify future leaders has never been more intense
 - The next decade will bring substantial business ownership handoffs



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INTRODUCTION

- *Businesses should have near-term business continuity plans and long-term succession plans*
 - Only one-third of U.S. family businesses have documented and communicated succession plans in place (*per study by PWC*)
 - Businesses that have not begun to plan are vulnerable to risk



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INTRODUCTION

- *Today's discussion will address:*
 - Shareholder Transitions
 - Valuation Considerations
 - Buy-Sell/Shareholder Agreements
 - Transitions Gone Bad – Shareholder Divorce



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SHAREHOLDER TRANSITIONS





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SHAREHOLDER TRANSITIONS

- *Thorough succession planning can facilitate growth of a business, reduce transfer taxes and ease senior leaders into retirement*
- *Understanding that the planning is both a critical and evolving process is more than half the battle*
- *The business owner(s), along with their advisors, are working together to formalize a plan for permanence*



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SHAREHOLDER TRANSITIONS

- *Time is critical on three fronts*
 - Advanced planning is far more effective than waiting until owner(s) are close to an exit
 - Sufficient time must be allotted for preparation for any transition
 - The implementation of a plan often takes much longer than anticipated at the beginning of the process



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SHAREHOLDER TRANSITIONS

- *Advisors that should participate*
 - Legal counsel – corporate and estate
 - Company accountants
 - Business valuers
 - Wealth advisors



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SHAREHOLDER TRANSITIONS

- *A plan for transition can include:*
 - Setting goals – both business and personal
 - Understanding value
 - Assessing talent and development of future leaders
 - Adopting strategies to preserve legacy of the business
 - Creating a long-term corporate governance plan



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SHAREHOLDER TRANSITIONS

▪ *Issues that should be addressed*

- Evaluating options for corporate finance structures – debt and equity
- Compensation planning – successors and other members of management
- Identifying value drivers, risks and other complexities of valuation
- Contingency planning
- Creating (and implementing) or revising shareholder agreements



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SHAREHOLDER TRANSITIONS

▪ *Creating and measuring value*

- Valuation is at the heart of all planning
- Process of identification of risk and value drivers of the business
 - Value is a function of assessing and quantifying future economic benefits and associated risk
- Understanding the difference between value and price



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SHAREHOLDER TRANSITIONS

- *Understanding the options*
 - Process of vetting through each alternative
 - Both internal and external options
 - Compare advantages and disadvantages of each option



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SHAREHOLDER TRANSITIONS

- *What are the options for transition (internal to the business)?*
 - Transfer to family members
 - Management buyout
 - Adopting an employee stock ownership plan
 - Partial sale transaction
 - Through use of a shareholder/buy-sell agreement



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SHAREHOLDER TRANSITIONS

- *What are the options for transition (external to the business)?*
 - Third-party strategic buyer
 - Third-party financial buyer
 - IPO




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SHAREHOLDER TRANSITIONS

- *Outcomes of transition planning*
 - Charts a clear path forward
 - Drives consistency and stability in decision-making process
 - Builds commitment on the part of senior owners and their successors
 - Provides a framework for responses to unforeseen events
 - Shareholders should have a clear understanding of exit options



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VALUATION CONSIDERATIONS



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VALUATION CONSIDERATIONS

- *Process*
 - Define the engagement
 - Scope
 - Deliverable
 - General valuation parameters



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VALUATION CONSIDERATIONS

▪ *Process*

- Data Collection
 - Financial and organizational information
 - Interview management
 - Industry and economic health



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VALUATION CONSIDERATIONS

▪ *Process*

- Analysis of Information
 - Historical and forecasted financial information
 - Normalization process
 - Identification of operational and financial trends
 - Industry and economic analysis



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VALUATION CONSIDERATIONS

▪ *Process*

- Method selection and application
 - Three broad approaches to value
 - Selection based upon specifics of subject company



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VALUATION CONSIDERATIONS

▪ *Process*

- Income-Based Approach
 - Discounted Future Cash Flows
 - Capitalization of Future Cash Flows
 - Future economic benefits and required rate of return



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VALUATION CONSIDERATIONS

▪ *Process*

- Market-Based Approach
 - Guideline Completed Transactions
 - Guideline Public Companies
 - Market-based valuation multiples to apply to subject company metrics



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VALUATION CONSIDERATIONS

▪ *Process*

- Cost/Asset-Based Approach
 - Asset Accumulation Method/Net Asset Value Method
 - Excess Earnings (Hybrid) Method
 - Typical for asset-laden companies or asset-holding entities



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VALUATION CONSIDERATIONS

▪ *Process*

- Formation of deliverable
 - Detailed report
 - Summary report
 - Letter report
 - Summary calculations



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VALUATION CONSIDERATIONS

▪ *Process*

- Additional transaction-related consulting
 - Post-closing adjustments
 - Synthetic equity valuation (financial reporting)
 - Purchase price allocation
 - Audit and tax services



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BUY-SELL/SHAREHOLDER AGREEMENTS



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INTRODUCTION

- *Importance of a Buy-Sell Agreement*

- Failure to address complex potential equity owner exit issues is one of the most prolific drivers of controversy and litigation among business partners
- Many of these negative outcomes can be easily avoided with a properly crafted buy-sell agreement



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INTRODUCTION

- *Timing of the Buy-Sell Agreement*
 - Inception/early stages of business life cycle
 - Alignment of interests
 - During later stages of business life cycle
 - Not always as smooth, but necessary
 - Later modification as circumstances dictate



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INTRODUCTION

- *Issues with no Buy-Sell Agreement*
 - No identification of applicable events
 - Lack of guidance
 - Lack of clarity



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INTRODUCTION

- *Core planning elements in consideration of buy-sell agreements*
 - Identify the parties to the agreement and the rights granted each party thereunder
 - Identify the available structures to allow for the selection of the one that presents the most desirable transition and tax outcomes



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INTRODUCTION

- *Core planning elements in consideration of buy-sell agreements*
 - Identify and define all appropriate trigger events
 - Identify and define the proper manner to set the price of the equity interests
 - Identify and define the terms of payment and the mechanisms by which the consideration will be paid



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FUNDAMENTAL CONSIDERATIONS

- *Elemental causes of poorly crafted buy-sell agreements date to the creation of the business itself*
 - Parties are more likely to be agreeable to a fair and reasonable buy-sell agreement
 - Goals and objectives of the business are in their closest state of synchronization to those goals and objectives of the equity ownership group at inception



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FUNDAMENTAL CONSIDERATIONS

- *Buy-Sell Agreement Fundamentals*
 - Buy-sell agreements generally provide for the following:
 - Timing of co-owner sales of their equity ownership interests
 - Whether the co-owner departure is mandatory or optional
 - What trigger events mandate the departure of a co-owner



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FUNDAMENTAL CONSIDERATIONS

▪ *Buy-Sell Agreement Fundamentals*

- Buy-sell agreements generally provide for the following:
 - How the value of the co-owner's equity ownership interest is to be determined
 - The terms under which the value of the co-owner's equity interest will be paid
 - The funding mechanism by which the exiting co-owner will be paid
 - Setting forth the means for dispute resolution



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FUNDAMENTAL CONSIDERATIONS

▪ *Critical Elements of Buy-Sell Agreements*

- Selecting the most appropriate type of agreement
- Setting restrictions on transferability of the equity interests
- Identifying the events which invoke the provisions of the buy-sell agreement
 - Trigger events: death, disability, default and divorce



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VALUATION

▪ *Standards of Value*

- Description of the “type of value” that is called upon by the buy-sell agreement
- The complexities associated with fully understanding the standards of value often requires detailed advisor input from both legal counsel and the business valuator



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VALUATION

▪ *Applicable Standards of Value*

- Fair Market Value
- Investment Value
- Fair Value Under State Statutes



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VALUATION

▪ *Premise of Value*

- Assumption of the most likely set of transactional circumstances
 - Going concern
 - Liquidation
 - Orderly
 - Forced



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VALUATION

▪ *The Valuation Date*

- Various dates of valuation often include:
 - The date of notification
 - The date of equity owner departure
 - The date of transaction closing
 - The last quarter or year end
 - The date of specific trigger event



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VALUATION

▪ *Business Valuation Protocol and Process*

- “Pre-Set” or “Fixed” Value
- Formulaic Determination of Value
- No Process of Any Kind
- A Full Business Valuation



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VALUATION

▪ *Case Law Examples of Problem Areas*

- *Arizona Tea, Ferolito v. Vultaggio* – NY Supreme Court, Nassau County, No. 004058-12
- *Fredericks Peebles & Morgan LLP v. Assam* (LEXIS 142)
- *Tate v. Tate* (LEXIS 1340)
- *Matter of the Estate of Maurice F. Frink*, No. 6-433
- *Etienne v. Miller*, No. F049110



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TRANSITIONS GONE BAD – SHAREHOLDER DIVORCE



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CAUSES OF SHAREHOLDER DIVORCE

- *Personal Use of Business Assets/Income*
- *Personal Behaviors of a Civil or Criminal Nature*
- *Use of Business to Advocate Personal Interests*
- *Financial Success/Distress in the Business*
- *Shareholder/Equity Owner Freeze Out*



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SHAREHOLDER DIVORCE RESOLUTION ALTERNATIVES

- *Single Equity Owner Buy Out*
 - Most common alternative
 - Exiting owner receives valuable consideration on investment
 - Remaining shareholders no longer need to deal with him/her
 - Issues: valuation and payment



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SHAREHOLDER DIVORCE RESOLUTION ALTERNATIVES

- *Sale of Business*
 - Extreme, but sometimes the only option
 - Completed transaction is negotiated by third parties
 - Can be achieved in a taxable transaction or tax-free basis



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SHAREHOLDER DIVORCE RESOLUTION ALTERNATIVES

▪ *Arbitration*

- Goal is to push to quick resolution without high cost
- Can be voluntary or mandatory; binding or non-binding
- Clauses directing arbitration often contained in governing documents

▪ *Mediation*



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SHAREHOLDER DIVORCE RESOLUTION ALTERNATIVES

▪ *Resolution in Court*

- Courts do not want to address disputes among business owners
- Few tools available for resolution
- Only become involved in limited situations
- Courts can appoint a custodian to run the business in place of the individuals involved in the dispute (not common)



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ROLE OF INDEPENDENT FINANCIAL SPECIALISTS

- *Type of dispute influences the assignment(s) requested of the specialist*
- *Specialist should have clear understanding of dispute*
- *Role of specialist can include*
 - Business valuation expert
 - Forensic accounting expert
 - Consulting and/or other support services



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VALUATION ISSUES

- *Valuation poses one of the most critical issues*
- *Failure to consider nuances can create issues*
- *Lack of a quality valuation can prove to be a costly misstep*
- *Critical to engage a qualified valuation expert*



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VALUATION ISSUES

- *Purpose of valuation*
- *Existence of a buy-sell agreement*
- *Valuation date*
- *Premise of value*
- *Standard of value*
 - In our experience, is often most material issue relating to value
- *Valuation adjustments*



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VALUATION ISSUES

- *Fair Value vs. Fair Market Value Standard*
 - Most states (including PA) use fair value to resolve shareholder disputes
 - Defined in the Revised Model Business Corporation Act
 - Some courts do not equate fair value to fair market value



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VALUATION ISSUES

▪ *Fair Value vs. Fair Market Value Standard*

Fair Value	Fair Market Value
Not always a willing buyer	Willing buyer
Not a willing seller	Willing seller
Buyer not always compelled; seller under compulsion	Neither under compulsion
The impact of the proposed transaction is not considered; the “fairness” to the seller is a possible consideration	Assumes a typical hypothetical buyer and seller
A concept of “fairness” to the seller, considering the inability to keep the stock	A price equitable to both



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VALUATION ISSUES

▪ *Fair Value vs. Fair Market Value Standard*

Fair Value	Fair Market Value
Does not assume that buyer and seller have equal knowledge	Assumes buyer and seller have equal knowledge
Does not assume reasonable knowledge of both parties	Assumes reasonable knowledge of both parties
Applicable only to minority blocks	Applicable to both controlling interests and minority blocks
The most common value standard in state dissenting and oppressed shareholder statutes	Applies to all federal tax valuations



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VALUATION ISSUES

- *Valuation adjustments*
 - Driven by:
 - Specific investment characteristics
 - Required standard of value
 - Methodologies applied



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VALUATION ISSUES

- *Valuation adjustments*
 - Buy-sell agreement may speak to the standard of value which will impact application of discounts
 - Absent governing documents, state statutes will provide authority
 - Application of discounts in a fair value context



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FORENSIC ISSUES

▪ *Oppression*

- Interpreted broadly among states
 - Most protect minorities and non-controlling equity ownership positions
 - Also possible to see actions brought in equal ownership arrangements



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FORENSIC ISSUES

▪ *Types of Malfeasance*

- Financial statement improprieties
- Asset misappropriation
- Fraudulent disbursements



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FORENSIC ISSUES

▪ *Forensic vs. Audit Engagement*

- Auditor’s job is to express opinion on financial statements based on audit and overall financial statement presentation
- Forensic Accountant’s job is to be more specific/focused with a general goal of defending and/or refuting in an advocacy arena rather than forming an opinion
- Selecting an accountant for forensic and/or fraud services



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RELEVANT CASES

- *Patel v. Siddhi Hospitality, LLC*, 312 Or. App. 347 (Or. Ct. App. 2021)
- *Parrish v. Schroering*, WL 1431604 (Ky. Ct. App. Apr. 16, 2021)
- *Owen v. Cannon*, C.A. No. 8860-CB (Del. Ch. June 17, 2015)
- *Staiger v. Holohan*, 100 A.3d 622 (Pa. Super. 2014)
- *Adler v. Tauberg*, 881 A.2d 1267 (Pa. Super. 2005)



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CONCLUSION



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CONCLUSION

- *Shareholder transitions pose a number of challenges*
- *Requires an integrated approach from a group of trusted advisors*
- *Requires discipline and sufficient runway to plan and implement*
- *A lack of planning can lead to a diminishment of business value and shareholder wealth*