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PLAN AHEAD: PUT EVERYTHING IN WRITING

IT'S ALWAYS BENEFICIAL TO BE PREPARED FOR VARIOUS EVENTUALITIES OVER THE LIFE OF BUSINESS OWNERSHIP. LIKE MANY THINGS, THE IMPORTANCE OF HAVING A WELL-DRAFTED SHAREHOLDER AGREEMENT ONLY COMES TO LIGHT AFTER IT'S TOO LATE. HERE ARE THE BASICS.

WHAT IS A SHAREHOLDER AGREEMENT?

A shareholder agreement is a formal document that outlines the expectations among the shareholders and their respective rights and obligations. Shareholder agreements can include many clauses that complement the statutes and articles of incorporation and provide mechanisms for dealing with a variety of events. Among others, this allows the opportunity to create a price mechanism for selling shareholders with continuing shareholders.

WHO SHOULD ENTER INTO A SHAREHOLDER AGREEMENT?

I believe any business with two or more shareholders can benefit from a shareholder agreement. Although discussing things like death, fraud, termination of employment and other items may sour the honeymoon phase of business formation, it is critical that these items and many more be dealt with as the business becomes established. This helps makes sure there are agreed-upon mechanisms in place in case events like these occur.

WHAT ARE THE CONSEQUENCES OF NOT HAVING A SHAREHOLDER AGREEMENT?

Examples abound in our advisory and litigation practice. One notable example was an empire built by a few shareholders and then one of them passed away. The shares became property of his estate. Disagreements over the management and distributions of the business between the existing shareholders and the estate led to a multiple-year legal battle which could have been avoided had an exit mechanism been in place, such as a mandatory buyout of his ownership interest upon death.

Likewise, having no exit mechanism when shareholders are in dispute can cause decision gridlock, harming the business over time due to decreased cooperation. An agreed-upon resolution mechanism, coupled with mediation or arbitration provisions, comes in handy, and avoids costly, formal and lengthy litigation.

WHAT SHOULD I PUT IN A SHAREHOLDER AGREEMENT?

There are many aspects that a seasoned commercial lawyer can draft within a shareholder agreement, but there are certain clauses that have significant impact on the value of an ownership interest during a forced or unforced sale (known as buy-sell clauses). A business valuator can provide assistance in the formulation of buy-sell clauses, which outline the valuation method(s) and conditions where one can sell or buy an ownership interest.

IF I AM SELLING, DOES A BUY-SELL CLAUSE REALLY HAVE AN IMPACT ON THE VALUE OF MY STAKE IN THE BUSINESS?

It has an impact on the price you will be paid for your interest, which could be significantly different from what your interest could be worth (i.e., value).

Absent these clauses, owners of a minority interest may find their backs against the wall during any buyout negotiations. The guidance in buy/sell clauses typically allows for a very transparent determination of value, agreed upon in advance between the shareholders.

SO WHAT IS TYPICALLY DONE TO ESTABLISH VALUE?

The two most common methodologies to establish value in buy-sell clauses are a) the adoption of a valuation formula and b) the appointment of a valuator when a triggering event occurs.

Valuation formulas are based on the company's financial information. These formulas can be based on multiples of revenue, some sort of profit metric, or other. They remain popular for a reason; they are simple to apply.

We often see formulas based on "book value," which is more an accounting term than a value term. In almost all instances, these types of formulas lead to an unreasonably low buyout price. For operating companies, using book value from the accounting records would fail to recognize the value from an established customer base, brand name, intellectual property, and general goodwill (which are never recorded as assets in the financials).

Should a valuation formula be used, it should be carefully crafted and revisited to ensure it does not become obsolete (inaccurate) as the business model and economic environment changes over time. It should also include considerations for assets held by the business but not used in operations (such as an investment portfolio or extra cash sitting in the business), as the formula may not capture these non-operating assets.

We are also often called upon to prepare valuation reports in situations where the shareholder agreement stipulates appointing an independent professional when a buy/sell clause is being put to use. This method reduces the likelihood of any pricing dispute. The value conclusion is more easily accepted between transacting shareholders, as the value result would be prepared by an independent party, who doesn't favour the buyer (who'd like to buy low) or the seller (who'd like to sell high). It is however, more costly than applying a formula, and production delays may arise as the valuator needs to gather sufficient information to draft a report.

ANYTHING ELSE I SHOULD KNOW?

The wording of the buy/sell clause is critical in ensuring there are no disputes as to its application.
Often, we examine agreements that are silent on a multitude of items that would provide direction to the business valuator. For example, in the event of death, should life insurance proceeds form part of the value of the shares for the buyout price? Failing to understand the implications of the wording can result in a wildly different conclusion from one's expectations.

IN CONCLUSION

Regardless of approach, businesses do change over time. Dusting off the shareholder agreement every now and again and updating the agreement ensures its relevancy over time in the event it is required, and can save years of headaches, professional fees and uncertainty.

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A specialist in business valuation and litigation support, George Hatzigeorgiou serves a highly diverse clientele whose sectors include manufacturing, services, distribution and retail, real estate, transportation, storage, and communications.

Within the scope of his role, George ensures the management of numerous valuation mandates. His work often entails the preparation of expert reports that address disagreements between shareholders, marital conflicts, minority squeeze-outs, and damages for lost revenue or investments. He is also called upon as an expert witness in court and to assist in settlement conferences; additionally, he offers sought-after skills in preparing limited critique reports, and fairness opinions. George's services extend to all matters pertaining to financial planning, mergers and acquisitions, and transfer pricing, as well as anything that falls within the financial and legal realms.

Well-known both for his expertise in business valuation, and keen business sense, George contributes greatly to our firm's rising value. He makes it a point of honour to provide the highest quality service to a growing clientele of managers and owner-operators, each of them eager to obtain the very best from their companies.

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