Viewpoint on Value

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Shareholder disputes call for valuation expertise

When shareholders fail to see eye-to-eye — for example, when minority shareholders oppose a major corporate decision or a controlling owner is accused of wasting corporate assets — the owners may need an appraisal to equitably part ways. But before valuing a privately held minority interest, an appraiser needs to address several issues.

Sibling rivalry

Shareholders sometimes disagree. To illustrate, consider the hypothetical example of Larson Brothers Pest Control Company. The eldest brother, John, owned 70% of Larson Bros. and wanted to merge it with his new wife's house-cleaning business. His three younger brothers — Paul, George and Ringo — each owned 10% of the stock and opposed the merger.

John hired a valuator who concluded that each 10% interest was worth $300,000 on a minority, nonmarketable basis, using the income approach. The appraisal included a 20% discount for lack of control and a 25% discount for lack of marketability. He offered to buy out his brothers' interests at this estimate of fair market value.

Meanwhile, Paul and George hired their own appraisal expert, who valued their 10% interests at $500,000 each on a controlling basis — two-thirds more than John's offer. Their attorney advised the expert to omit valuation discounts in accordance with the 1999 Revised Model Business Corporation Act, which defines fair value as:

> The value of shares immediately before the corporate action to which the dissenter objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal, and without discounting for lack of marketability or minority status except, if appropriate, for amending to the certificate of incorporation pursuant to section 13.02.

The youngest brother, Ringo, hired a third expert who adjusted the company's income stream for excessive discretionary expenses, including $150,000 for above-market owner's compensation paid to John and $50,000 paid to his wife in "management fees." His expert valued Ringo's 10% interest at $600,000 on a controlling basis, which was double John's offer.

For simplicity, this hypothetical example assumes that all other valuation assumptions were consistent among the three appraisers. In reality, appraisers might differ in other valuation parameters, such as projected income streams, capitalization rates and methodology. However, the example shows the importance of addressing valuation issues

— such as the appropriate standard of value, valuation discounts and adjustments, and the effective appraisal date — before valuing the business. If they aren't addressed, different experts may arrive at significantly disparate values.

Different standards

Each appraisal assignment requires its own particular standard of value, depending on the circumstances. John's expert calculated fair market value, but dissenting and oppressed minority shareholder cases typically require fair value. This standard of value is statutorily defined and varies from state to state.

In many jurisdictions, courts exclude discounts for lack of control and marketability when computing fair value. That's because the buyers and sellers are known and the statutory buyout creates an effective market for the minority interests.

The theory underlying the omission of valuation discounts is that purchasing a minority interest for less than a pro rata share of the entire business's value provides a windfall to controlling shareholders. And in many cases, the buyers (the controlling shareholders) have defrauded the business, wasted corporate assets or otherwise oppressed minority owners. It should be noted that New York routinely permits discounts for lack of marketability in minority buyout cases.

Getting back to normal

Valuators sometimes make well-reasoned adjustments to the subject company's income stream before applying the market or income approaches. In our hypothetical scenario, Ringo's expert adjusted the Larson Bros. income stream for above-market owner's compensation and management fees.

Appraisers also make normalizing adjustments for such items as extraordinary events, discontinued operations, and nonrecurring income and expenses. Attorneys and appraisers need to discuss which adjustments are appropriate in shareholder disputes.

It's about time

Ambiguity may exist concerning the effective valuation date. And values can swing significantly over time in an uncertain economy. The most common effective dates in minority shareholder litigation include the day before the corporate action to which the dissenter objects, the date of court filing and the trial date.

A valuator also may need to factor in events that occurred after the valuation date, such as a subsequent sale. Another consideration is whether there's any appreciation or depreciation in value from a proposed corporate action.

Forethought is imperative

Appraisers specialize in business valuation and financial issues, not in legal matters. An experienced appraiser discusses these issues with the attorney to determine the valuation's purpose, taking into consideration any statutes that may apply, as well as the

applicable standard of value. The appraiser then succinctly defines the assignment in writing before valuing the business.

Do you have a **Question?** or want to speak to

Michael B. Lehner
CPA/ABV, CFE, ASA

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