The Family Business Advisor

THE FAMILY BUSINESS CONSULTING GROUP

Shareholder Agreements: Parting Ways

By: Ross Nager, Family Business Advisor Contributor

Can you name two types of agreements that can be divisive when you create them, but reduce problems when things fall apart? Yes, despite the advertised benefits of setting the terms by which shareholders hold and transfer their stock, many family businesses still lack shareholder agreements. I find them to be among the two most discussed, but perhaps most difficult to implement, documents in the family business world.

Though simple in concept and intent, shareholder agreements raise issues that can be terribly complicated and emotionally challenging. Many families will not even discuss them. So, they miss out on a key way to protect their businesses and reduce future family friction.

In this and a few future columns, I seek to demystify these agreements and provide some insights to help your family face up to underlying issues that get in the way of implementation.

Despite their legal structures, family and other closely held businesses are like partnerships. Partners typically choose their partners. For example, my brother married his wife; I did not. Although I like her, I do not necessarily want my sister-in-law as a partner if she inherits my brother's stock when he dies.

A shareholder agreement is a contract governing the ownership and transfer of shares. Like other contracts, it can contain or omit almost anything to which the parties agree. Most commonly, the agreement restricts stock transfers and the types of people who may own shares. Ah ha! you exclaim. This is how I make sure that my 26-year-old throw-back-to-the-60's son-in-law can't coerce my daughter to transfer her stock to the Save the Hungarian Whales Foundation!

Unfortunately, it's not that easy. Corporate law typically does not allow a total prohibition against stock transfers. So, while a shareholder agreement might prohibit transfers, it must address what happens if a shareholder violates the terms. The most common result is that the offender (or the receiving party) becomes obligated to sell the shares that were improperly transferred. Therefore, shareholder agreements are often called buy/sell agreements.

Permitted Transferees

The agreement should define persons to whom stock may be transferred without triggering any implications. They often include:

- Descendants of current owners,
- For post-first generation businesses, descendants of the business founder (permits a childless owner to transfer to siblings, nieces and nephews, etc.),
- Trusts for the benefit of the above persons, and
- Partnerships or other entities that are owned solely by permitted transferees.

Here's the first touchy issue. Should shareholders spouses (aka my sister-in-law) be permitted transferees? If not, my brother may have to pay estate tax to pass his stock to his children. So, we might include marital trusts as permitted transferees, which in turn allows the estate tax to be deferred until his wife dies. As a compromise, we could require that only permitted transferees may be a) trustees and b) residual beneficiaries at the in-law's death.

Triggering Events

Next, the agreement should specify events that can trigger consequences. Obviously, transferring the stock to someone other than a permitted transferee should trigger the agreement's wrath. Other examples might include:

- Pledging the stock as collateral for a loan,
- The shareholder's insolvency or bankruptcy,
- Retirement, disability or termination of employment for any reason (although these tend to be uncommon triggering events for family owned businesses),
- The owner's death unless the stock is transferred to a permitted transferee, and
- Distribution from a trust or other entity to a non-permitted transferee.

Consequences
What happens when a triggering event occurs? The typical consequences are one or more of the following:

- The violator or the resulting non-permitted owner is required to sell the stock,
- The company either has the option or is required to buy the stock (a redemptive agreement), and/or
- The other shareholders either have the option or are required to buy the stock (a cross-purchase agreement).

Agreements typically require the violator or non-permitted transferee to sell, but give the company or remaining shareholders the option to buy. This might be another touchy issue. If you think you might want to cash in your stock one day, you'd like the right to force the company or other shareholders to buy your stock. Conversely, if you want your family members to continue to own the stock or you're not sure that you'll have the money, you'll naturally want the flexibility of having an option, not an obligation, to buy.

Needing Dough
Where does the buyer get the money? Life insurance folks have the answer. But, there are several problems with that solution:

- Life insurance can fund only one of the possible triggering events (death).
- The insurance might be needed to pay estate tax, not to buy back stock from your son's special friend who inherited it.
- You need to make sure that the right person owns and is the beneficiary of the insurance. The company must receive the proceeds for a redemptive agreement. Each shareholder must own insurance on all other shareholders lives for a cross-purchase, which gets rather complicated.

The more common approach is to provide very generous (from the buyer's standpoint) payout terms. For example, the agreement might specify a 10% down payment, with the balance payable over 10 years at the lowest interest rate allowed by the tax law.

Buy/sell agreements create order when shareholders split because they set the terms of the business divorce. So, what makes creating one so incendiary? We'll get to the tougher aspects next month.

In the meantime, did you think of the other type of agreement that can be divisive at the start and create order at the end? Yep, prenuptial agreements probably are the toughest for family business owners to discuss and adopt.

The Valuation Conundrum

If a current shareholder intentionally or unintentionally transfers stock to a non-permitted person, the agreement specifies how the stock may be returned to appropriate hands.

It is the equivalent of a prenuptial agreement, since it sets the terms of a business divorce should the undesirable event ever occur in the future. However, despite the noble objectives, many families have trouble discussing and agreeing to some of the most critical terms.

Perhaps the toughest provision of all is valuation. Since the triggering event may not occur for many years or even decades, it is wise to set a mechanism that will self-adjust based upon changing conditions.

There are numerous ways to set the pricing mechanism, but they can be divided into several categories.

Book Value
Book value is the difference between assets and liabilities on the balance sheet. A multiple or fraction of book value probably is the most common valuation approach. It is simple, easily understood and easily calculated.

Unfortunately, book value only coincidentally equals a business fair market value. In fact, book value probably is the least accurate way to estimate fair market value because it:

- Can be manipulated through choice of accounting methods.
- Reflects historical asset cost, not current asset value.
- Reflects past earnings, not future earnings potential.

The latter point is particularly important for most family businesses. For example, assume two businesses, each with a book value of $1 million. The first business is expected to generate annual profit of $500,000, while the second only $10,000. Do you think both are worth $1 million? If you do, give me a call. I have a nice bridge for sale.

Periodic Revisions

Some families punt on the valuation question by agreeing to meet periodically to set a new stock price. This approach allows the family to adjust the value for changes in business conditions.

Sounds reasonable, but there are some significant cons (not referring to family members who disagree with you the next time shareholders meet to set the value), including:

- As long as no one wants or needs to sell, it is easy to agree on a new value. However, if someone is considering a sale, you can bet that the next meeting will become a major negotiation. That defeats the buy/sell objective of avoiding negotiations when tensions are high and interests diverge.
- In my experience, families just don't seem to get around to doing it. Since the most recent value sticks until the parties agree to change it, the price tends to get rather stale.

Appraisal

An independent appraisal is, at least theoretically, the most accurate way to determine fair market value. Why? A good appraiser considers not only history, but also current asset value and future earnings potential. Granted, appraisers are not astrologers, but at least they consider facts and trends at the time of the transaction.

There are a number of cons (not referring to appraisers who disagree with your view of value), including:

- The shareholders don't know what their stock value is from time-to-time unless the company periodically incurs the cost of an appraisal.
- Appraisals are somewhat subjective. Qualified appraisers may come up with different values. However, appraisers usually fall within a reasonable range if they are truly independent, unbiased and given the same information. Pay attention to buy/sell provisions concerning appraiser selection and the appraisal process.
- A major potential point of contention is discounts for lack of marketability and control. Perhaps the family should agree to the size of these discounts and not leave it to the appraiser's discretion. The agreement can instruct the appraiser accordingly.

An appraiser friend says he knows he has found fair value when both sides are mad at him! That speaks volumes. It might be better for family members to be mad at the appraiser than each other!

Formulas

For operating businesses, appraisers usually place great weight on multiples of earnings and/or cash flow. The multiples are based on price-to-earnings and similar ratios of comparable public companies. To avoid appraisal costs, you could use these types of formulas in your buy/sell to approximate fair market value.

An informed approach to selecting formulas is to ask an appraiser to describe the primary mechanics he would use to value your business. Those mechanics become formulas specified in your buy/sell agreement.

Downsides include:

- Formulas don't do too well at peaks and valleys of business cycles. For example, using a multiple of the average of the past three years earnings could yield a high value, even though conditions indicate the beginning of a downturn. Conversely, formulas would tend to undervalue a business that is starting a business upturn.
- Results can be affected (some might say, manipulated) by tinkering with the underlying

components. For example, if you want to lower the company's earnings-based value, pay yourself a bigger salary. An objective appraiser would adjust out the effects of such unusual items. A formula-based agreement can spell-out adjustments, but might not adequately anticipate subsequent creative management or changing business conditions.

- Formulas should be changed when there is a major change in the type of business or the assets owned by it. The bigger issue is whether the shareholders will agree to the change at that time.

The Real Problem

Picking a valuation technique would be easy except for one little bitty question. WHO GETS BOUGHT OUT FIRST AND WHO HAS TO PAY FOR IT? Actually, I guess that's two questions.

If you think you'll be the first to sell, you'll argue for a valuation approach that will yield a high value. If you want the business to remain in the family forever, you want a low value to discourage family members from selling. As the debate over pricing gets more heated, other issues are brought to the surface. The entire process turns into a quagmire and grinds to a halt.

That raises another question for family business leadership. Do we really even want to let this genie out of the bottle? Maybe we should just not bother with a buy/sell agreement. It's like that darn prenuptial agreement. We're really happy together now. Why risk messing up our relationship by talking about what will happen if we ever need to split up?

The Value Equations

Our buy/sell agreement saga continues with some thoughts about the dynamics of family discussions on a potentially sensitive topic. If you have more than one shareholder over 12 years old (or any adult shareholders who act about that age), you're virtually guaranteed to get bogged down on valuation.

In my experience, numerous behind-the-scenes issues can affect family members positions on stock value. The symptoms come to the forefront if some family members want to keep the business in the family forever, while others think they might want to sell someday. If the family members look at it that way, the natural result is that the buy/sell agreement discussion becomes a negotiation between buyers and sellers.

After years of study, applying very advanced algebraic principles, I've developed a scientifically accurate equation to express mathematically how each camp might calculate the stock price. In each case, we start with the most objective value possible - the value determined by the most competent, informed and unbiased appraiser we can find.

Unfortunately, it is a mathematical fact that the two equations never result in the same value.

After family members have staked claims to one side or the other, a role-play might be amusing, if not helpful. Ask them to negotiate and defend the opposite point of view. That should improve everyone s understanding of the issues.

What if that psychological approach does not shrink the difference between two sides amounts? If there is some love in the family and everyone views the business with at least some respect, it may be possible to find common ground by asking some soul-searching questions, like:

- Is family harmony worth giving in a bit on each side to avoid resentment that can tear the family apart?
- Doesn’t a low price force people to stay as shareholders? If so, doesn’t it just cause them to get more frustrated over time with the risk of creating outright war (meaning a windfall for the lawyers) when they can t stand it anymore? Conversely, doesn’t a high price encourage people to sell and put undue financial stress on the business?
- If a significant number of shareholders want to sell the business, shouldn’t those who want to stay pay a premium to keep it?
- Do you care about the success of the business, its employees and its customers? If so, shouldn’t the price be kept reasonable to avoid putting undue burdens on the business?
- If some of the owners want to cash out, isn’t it reasonable to expect that the business either must contract or forgo some expansion plans until it generates replacement capital?

Valuation by Those Who Envision Keeping Their Stock Forever (The Buyers)	Valuation by Those Who Envision Selling Their Stock Someday
START: Value of stock per an objective, competent and informed appraiser.	**START:** Value of stock per an objective, competent and informed appraiser.
- Discount because I do not believe the appraiser. - Discount for illiquid/non-controlling shares. We can't afford to buy back stock as if we are selling the whole company. - Discount because you (the seller) won't be taking any risk that the company performs poorly after the sale. - Discount because you didn't work here and didn't contribute to creating the stock value. - Discount because you got your stock by gift and inheritance. You never put any capital into the company. - Discount because I don't want the kids to get too much money for work ethic and moral values reasons. - Discount because I don't want the seller to take advantage of me. - Discount because I want to discourage people from selling. - Discount because the business can't afford to buy people out. We need the money for capital and other needs within the business. - Discount because I don t want the IRS to think the business is worth so much for future gift/estate tax purposes. = The price I am willing to pay for your stock, but I don't want you to sell and the family will be forever peeved if you do.	+ Premium because I do not believe the appraiser. + Eliminate any discounts for lack of marketability/control because they're not fair. + Premium because I won't benefit if the company does well after I sell. + Premium because I never got all the salary and perks that the other family members received. + Premium because I never got a dividend for the company's use of my capital. + Premium because I need more money. + Premium. I don't want the buyers to take advantage of me. But I don't want to stay and it's not fair for you to cheat me out of my share of the value. Baloney! Look at the big numbers on the balance sheet and the high income. Quit taking so much salary and there will be plenty of money to buy me out and spend on unnecessary business projects. That's not my problem. = The price I am willing to accept, but I'll still feel cheated if the business is successful and you become wealthier than me.

Let My People Go

Buy/sell agreements are among family businesses most important documents. Well, that may be a bit melodramatic, but I am dedicating this fourth (and final yea!) column to the subject. Many business owners won't discuss buy/sells for fear of the consequences. As a result, they miss an important opportunity that goes far beyond the document's legalistic purposes.

One group will be all ears (and vocal cords) if you raise the buy/sell subject to those who might want to split one day. Indeed, that is the crux of the matter. If you think that someone might want to sell one day, you probably won't raise the subject. Or, you'll start the discussion and get bogged down on the pricing.

Sure, you can argue for a low price that prevents them from selling. That's the stick approach. How about offering the carrot instead? Perhaps it would be better to find ways to motivate people to want to keep their shares. But offering the carrot requires you to find out what might motivate them to want to sell and, more importantly, to want to stay.

So, the key to the buy/sell story is that you must talk in-depth about it. It should not be primarily a negotiation about price. Rather, use the potential price impasse to explore a series of important questions and issues:

- If you think a higher price is appropriate, why? Conversely, if you think a lower price is appropriate, why?
- What are each family member's feelings behind why they favor those who might choose to stay or leave and, therefore, benefit or suffer from the pricing preference?
- Then, discuss the possible consequences to the departing and remaining shareholders and to the company.
- Then, don't try to change others views on buy/sell pricing. Instead, ask, What can we do to resolve the underlying issues raised as a result of these discussions?

Yes, these discussions might let the proverbial genie out of the bottle, unleashing pent up anger and frustration. Moses words to Pharaoh come to mind. Let my people go. In a family business, you can get away with holding family members as shareholder-hostages for a while. But, the result can be a building of tensions that culminates in problems far greater than the cost of letting them leave gracefully and on fair terms if they really want to go. Wouldn't it be better to discuss their concerns now, rather than waiting until they decide to hire a lawyer to facilitate their departure?

Don't Bail Too Fast

For those whose desire for a high price underlies a personal desire to sell, I have a few thoughts. When I was growing up, I had a piggybank. Well, actually it was a metal replica of a bank building. But, I called it my piggybank. I put coins in whenever I could. I rarely took money out, although I could. After all, it was my piggybank. It was my money.

My premise has always been that unwilling shareholders should not be held hostage. If they really want out, let them sell if at all possible. But, you should consider the consequences of selling.

Think twice before you decide to buy that new house by redeeming some shares. Unlike cashing in some Intel stock, you probably can't replace the family business shares you sell. You will be permanently affecting your and your descendants future rights and involvement in the business. It can create resentment and alter voting relationships within the family.

Selling your stock can have a serious impact on business operations. It's not just your piggybank. The livelihoods of your employees, customers and others can be affected if your demands are too high.

Understand that family members who will remain shareholders want a viable, ongoing business. There is a limit on how much the company can afford to pay to buy back its shares. Is it fair to expect your family members to risk the business and their future livelihoods for you to be able to cash in your stock on a whim or for an excessive price?

Raiding the piggybank was no big deal when you were a kid. The stakes are much higher when you consider a raid on the family business. Approach the issue with care, good advice and a very long-term perspective. Make sure that you truly understand the real reasons you want to sell shares. Work with your family to explore alternatives to dealing with the issues that might motivate you to sell. If you must, you must. But, trading your heritage for short-term benefits may not be the right decision.

Fair Agreement

I have found that the existence of a fairly priced buy/sell agreement actually reduces family stress. Once people know that they can sell, and get a fair price, their desire to do so often dissipates. Perhaps the reason is that they finally face the finality of the consequences of selling, and back down.

Hopefully, your buy/sell agreement will stay in the desk drawer. But, if ever someone wants or has to leave, they should be allowed to do so with grace, dignity, compassion and a sense of fairness. If you can't stay in business together, a fair agreement at least will help to ensure a continued healthy family relationship.

Approach the buy/sell discussions in this spirit, and you will dramatically improve the odds of having a shareholder agreement, not just a draft. And, you'll decrease the chances that anyone will ever trigger it!

To learn more about our firm and how we serve families like yours, call us at (773) 604-5005 or email us at info@thefbcg.com. There is absolutely no obligation.

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