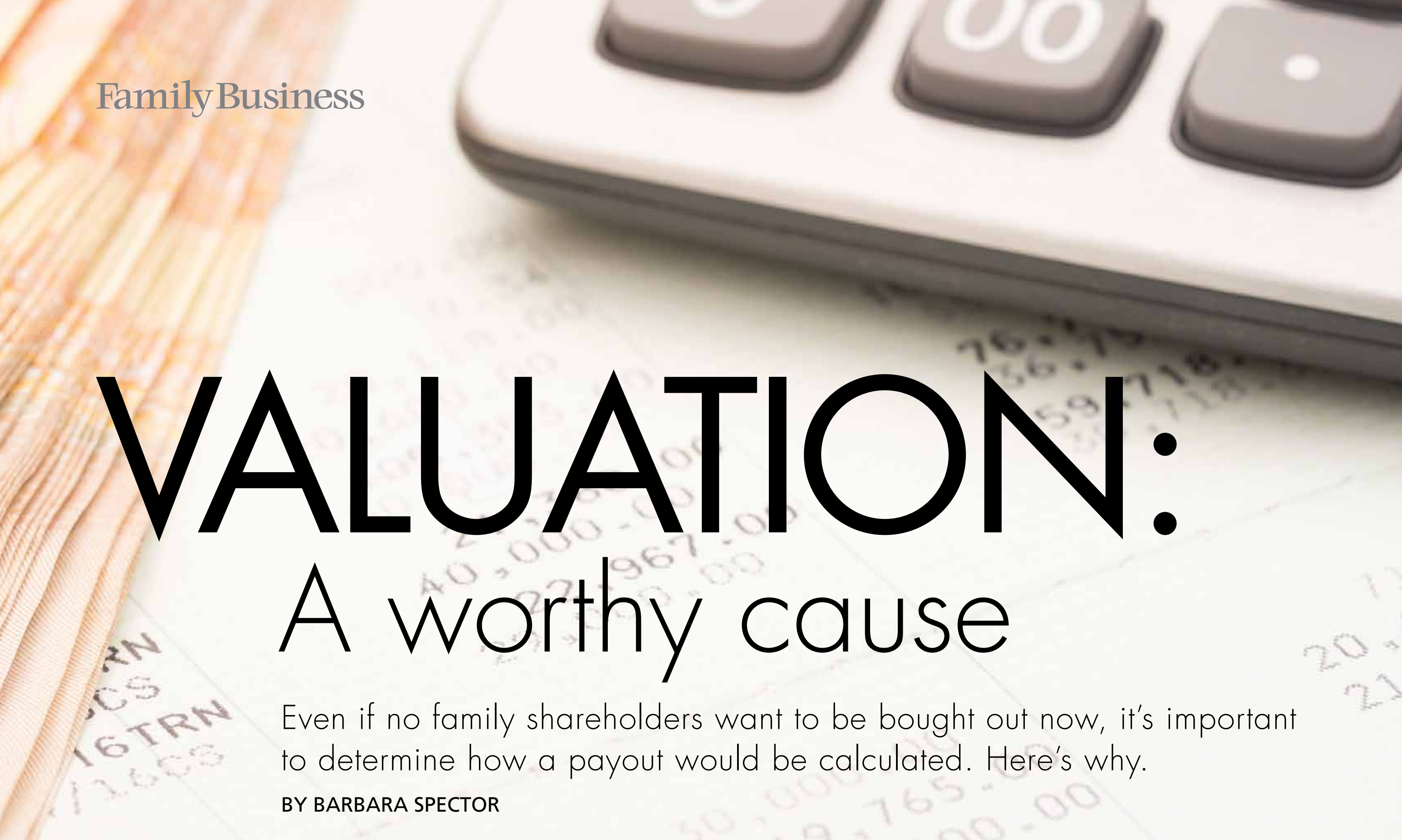

VALUATION:
A worthy cause

Even if no family shareholders want to be bought out now, it's important to determine how a payout would be calculated. Here's why.

BY BARBARA SPECTOR

Most multigenerational family companies eventually will buy out a family shareholder, or at least redeem some stock held by a family member. Sometimes it's the culmination of a planned transition (a retirement), but often it's emotionally fraught (a payout to heirs after a shareholder's death or a dispute that culminates in someone's exit). No matter the circumstances, a disagreement over the price can turn a good situation bad, or make a bad situation worse.

Families should not view a shareholder exit as shameful or unthinkable, says Travis W. Harms, who leads the family business advisory services group at Mercer Capital. "It's common, and it does not mean that your family or your business is a failure.

"Different family members have different needs and different interests, and continuing to own shares in the family business may not be appropriate for every member of the family. That's not a good or bad thing. That just is what it is."

Agita remedies

Many disagreements over payouts are rooted in shareholder education shortcomings. To explain how uninformed family business owners see it, Harms offers an analogy: Suppose you want to liquidate an investment account managed by a stockbroker on your behalf.

"The broker says, 'Well, in order to liquidate your account, I will give you $100,000.' The broker's never told you historically what's in the account. You have no idea how it's performed. All they're doing is saying, 'I'll give you $100,000 for your account.' "

Developing a buy-sell agreement — and explaining the details — can help prevent or manage conflicts. A buy-sell establishes the mechanism for the purchase and sale of shares upon various triggering events (a shareholder's resignation, termination, retirement, disability, divorce or death) and how the shares will be valued.

"The smart [families] do a good job putting these sorts of agreements in place ahead of time and helping people understand them," says Stuart A. Smith III, managing director, strategic family business advisory services at Wilmington Trust. "The really smart families also continually educate their family members, so that as they are faced with these situations, it's not a surprise — 'My brother's saying it's worth this much, but I'm not so sure.' "

"If you're going to buy someone out," Harms says, "then I think you will sleep much better at night when you do so having had a history of regular, quality communication with the shareholders about the business, and ongoing education for the shareholders about what business valuation means, and the risks and the prospects for the business, and the risks and rewards for owning shares." Communication will ensure that owners who request a buyout are making an informed economic decision.

The Allyn family — who owned Welch Allyn, a medical device manufacturer based in Skaneateles, N.Y., for 100 years before Hill-Rom acquired it in 2015 for about $2 billion — developed processes for redeeming family mem-

bers' shares and establishing a value. "If you were to talk to a person in my generation, they would say they understood the value of the company from, say, 2000 until the sale [to Hill-Rom]," says Eric Allyn, the fourth-generation former chairman of Welch Allyn.

"They might not be able to say how it was calculated, but they would generally know that there was a third-party firm who did this for us every year."

Even family members who preferred not to delve into the details of share valuation understood that "there'd be no room for argument" about the price if they wanted or needed to sell shares, Allyn says.

What's it worth to you?

One reason for confusion over valuation is that there's more than one way to value a company.

All too often in family businesses, family members are unaware of these distinctions. "They don't understand how the companies get valued, and they don't understand what it means to them — because nobody's explaining it," says Amy Wirtz, a consultant with The Family Business Consulting Group.

"People tend to have stars in their eyes about what the business is worth," says Smith.

"If a family business decides to get a valuation to help the board assess what the company might be worth in the event of a sale, then [the valuation firm is] probably going to make that assessment at the highest level of value," Harms says. "And just because a family member gets a whiff of that does not mean that that's what their shares are worth today if they elected to sell their shares to the company."

The amount of an exiting shareholder's payout may differ depending on the circumstances, says Wirtz. (For example, a shareholder who is fired from the company might receive a lower payout or, in cases of egregious misconduct, no payout at all.)

"Not only should the people running the company understand it, but also the people who would inherit the liquidity should there be a death," Wirtz says. "It's challenging, because most people don't want to talk about their triggering events, mainly because it envisions some sort of radical change."

Asset valuation, which calculates the value of a company's assets, is often used when the company owns real estate. Shareholders may not realize that owning a 15% in a business with real estate holdings entitles them to 15% of the earnings from the real estate, not 15% of the real estate itself (unless the business is being liquidated).

The income approach to business valuation looks at the company's cash flow and compares it to the risks the business faces.

Book value is the difference between a company's total assets and its total outstanding liabilities. Book value is easier (and less expensive) to determine than fair market value, defined as the price at which a property would change hands between a hypothetical buyer and a hypothetical seller when no one is under compulsion and both parties have reasonable knowledge of the facts.

Because it's typically lower than fair market value, book value is useful for estate planning and is often specified in family companies' shareholder agreements. Using a lower value can help owners stay within the lifetime exemption limit for federal estate taxes. In addition, a lower payout makes less of an impact on the company's balance sheet.

"It's great — if everyone is on the same page," Wirtz says. But if heirs don't understand why their payout is based on book value, "they feel ripped off, and it causes turbulence."

In the absence of a buy-sell agreement that specifies a valuation method, courts will use fair market value, Wirtz says. "And the problem with that is, most of the time when people are in court, it's not a willing sell and a willing buy," she notes.

A common benchmark for determining fair market value is the stock price of comparable public companies. The shares may be subject to a discount from the benchmark price if the exiting owner has a minority interest. A discount may also be applied for lack of liquidity of private company shares.

"It's an interesting dynamic," Smith says. If the exiting minority shareholder were to sell their stock to a third party, it's easy to understand why a minority discount would be applied. "But it's a little different when you're selling to folks that actually have the controlling interest, because they'd be expanding their control.

"They're the one buyer in the universe that can really benefit from picking up that incremental block of shares."

How should you pay an exiting shareholder?

Travis W. Harms, who leads the family business advisory services group at Mercer Capital, says family business leaders have three options to consider when determining the appropriate value for paying out a departing shareholder.

• **Non-marketable minority value.** In privately held family businesses, shareholders cannot obtain ready liquidity the way they can with shares traded on the public market. In addition, most exiting shareholders don't own a controlling interest in their family firm.

"From the perspective of a hypothetical willing buyer of your interest, they are going to take both of those negative factors into account," Harms says. "They will value the company on a minority interest basis, and then take a marketability discount from that — effectively penalizing the outgoing shareholder for the lack of liquidity in the shares." If the exiting shareholder is leaving because of a family dispute or has been fired from the company, the remaining shareholders may feel the penalty is appropriate.

The downside: Some states have laws prohibiting the application of discounts for lack of marketability in buyouts of minority shareholders.

• **Forgo the discount for lack of marketability.** Some families opt not to penalize exiting shareholders for selling stock in a family business that has elected not to go public. The rationale here is that the buyer — whether it's another family member or the business itself — is not just any hypothetical willing buyer.

The downside: "That can lead to problems if the departing shareholder does sell on that basis and then one, two or three years later, the company is sold in a change-of-control transaction at a higher price," Harms says. "Memories are long, and that will be a sore point between the departing shareholder and the remaining shareholders."

• **Change-of-control value.** This is the highest level of value. It recognizes that "when a shareholder departs, what they are giving up is ultimately the right to participate on a pro rata basis in the eventual sale of the family business if and when that were to occur," Harms says. A buyer who will control the company will likely pay a higher price than a minority investor. "Under this option, you're effectively prepaying the departing shareholder for their share of the value of the business from a control buyer's perspective."

The downside: "If you pay the departing shareholder a controlling price, but then the company does not sell for a long time, the remaining shareholders are likely to resent the fact that the departing shareholder got a higher value than they've realized over their holding period," Harms says.

"Of these three options, none is inherently or morally right or wrong," Harms points out. "They're just different ways of doing it."

— Barbara Spector

Buyers vs. sellers

Over the century that the Allyn family owned Welch Allyn, no shareholder ever requested an exit. But because of what Allyn refers to as "the obsession that my family has about managing estate taxes," the business paid scrupulous attention to valuation.

Family members gifted shares down to the next generation to avoid estate tax consequences, Allyn explains. In pursuing this strategy, they wanted to ensure the holdings they gifted would not exceed the IRS's lifetime gift tax exemption — the total lifetime amount a person can give tax-free in addition to the annual gift tax exclusion. The lifetime exemption is currently $11.4 million, but between 2002 and 2010 it was capped at $1 million.

Valuation of Welch Allyn shares helped the family's charitable giving. "Back in the time we owned the company, we actually didn't have a lot of cash, but our shares were worth a lot," Allyn says. "My wife and I would, on occasion, gift shares to a not-for-profit." The recipient organization redeemed the shares to receive the value. "Typically, they would do it that quarter or at the end of the financial year," Allyn says.

"We would do quarterly valuations. We would use the same numbers for charitable gifting and for intrafamily gifting. And if anyone needed to be bought out, it would be the value at which the company would buy someone out."

Occasionally, family members would redeem shares to obtain cash in lieu of borrowing. A relative of Allyn's, for example, did so to fund a divorce settlement. "He sold shares back to the company, generated the cash at the same valuation, and that was part of his settlement with his ex-wife," Allyn says.

The same valuation also was used for phantom shares in Welch Allyn's long-term incentive plans for non-family executives. Some executives received phantom shares, and some also had phantom stock appreciation rights.

In share redemptions, as in any other sale transaction, the seller hopes to receive a high price, while the buyer aims to pay the lowest amount. If the family members on either side of the transaction are fighting, arguments over the value will further polarize them.

Allyn notes that members of his family were both receiving shares from their parents and grandparents and gifting shares to their own children and to charitable organizations. "That tells you that it really was a true market," he says.

"The fact that I was both receiving and giving shares [meant that] I was implicitly — no, *explicitly* — agreeing that the value makes sense."

Putting it in writing

The optimal time to create a buy-sell agreement and develop a stock redemption program is when the shareholders are on good terms. The agreement should specify how the value of the shares will be determined.

"If we can get together today, when we are both getting along — and I don't know if I will in the future be a buyer or a seller, and neither do you — we both can agree that if one of us needs to go, this [procedure] will be fair," Harms says.

"And then, five years from now, when we do get into a fight, and we decide that I am the one who has to leave, I will have been committed already to what is the appropriate level of value. And so will you. And that greatly increases the odds that we can execute this transaction with as little heartache and pain as possible."

The wording of the agreement should be specific, Wirtz advises. "A really well-written agreement is going to say, 'The valuation firm we are going to hire is X' — which is a named company — or, 'The person we use has to have these credentials.' " Some companies put the names of several firms (perhaps recommended by the business's lawyer or accountant) into a hat for a drawing.

Even with this provision in place, one of the parties may not like the resulting number and will hire their own expert to prepare a second valuation. A detail-rich agreement will ensure both valuations are based on the same data, Wirtz says. For example, if the income method of valuation is specified, which years will be assessed (e.g., the trailing three years vs. the trailing five years)? How will adjustments be made for one-time highs or lows?

It's also a good idea to spell out who will pay for the valuation, Wirtz says. "Does the company pay for it? Does the individual pay for it? What if there's more than one?"

Many agreements state that the company will pay for the initial valuation. If one party doesn't accept those numbers, they can commission another valuation at their own expense. "If the two experts can't help the parties agree on the process, a third can be hired to mediate the two valuations' opinions and come up with a final number," Wirtz says.

Most high-functioning family businesses need only one valuation from a mutually selected firm, she notes. "But if relationships are really in distress, you want to have some process in place to break the tie between the experts."

Like most family business shareholder agreements, the Allyn family's agreement included restrictions on the transferability of shares to prevent non-family members becoming owners of the company. Shareholders who wanted to sell shares had to offer them first to other shareholders (their siblings or children — not to the senior generation — to avoid estate-planning issues) and then to the company. "It basically specifically excluded selling to outside parties," Allyn says.

Keeping current

It's important not only to create a shareholder agreement with a buy-sell provision, but also to review it regularly to ensure it remains current.

"Markets change, and that can have a significant impact on the valuation," Smith says. "We've definitely seen situations where there is a shareholder agreement, but it's been in a drawer for 10 years. The industry's changed, and the valuation metrics in the industry are very different.

One reason for confusion is that there's more than one way to value a company. All too often, family members are unaware of the distinctions.

"You've got to make sure that you continue to update [buy-sell agreements] and treat them as living, breathing documents. Because that's going to be far cheaper than the agita that you might endure if there are big disagreements down the line."

As the healthcare industry changed over the years, it became challenging for Welch Allyn's valuation firm to find peer companies for benchmarking.

"Choosing the peer companies was probably the biggest variable, and the most important variable," Allyn says. "Many of our peers were being acquired in the last three or four years of doing valuations. We went from having a peer set of 15 companies down to maybe only 10 companies."

The Welch Allyn board had to approve changes to the peer companies used in the valuation, Allyn says. "If you went changing companies out left and right, then people could be [accused of] manipulating numbers."

As is true of so many other family business issues, planning and process will help prevent unpleasant surprises when share redemptions are needed. A shareholder agreement with a buy-sell provision will help reduce conflict, as long as family members understand the wording and the reasoning behind it.

"There are hundreds of really high-functioning family businesses that never look at these documents," Wirtz says. "But they're really glad that they're there if they need them." FB