Defining "Value" in Ownership Agreements

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Articles of incorporation, articles of organization, and partnership agreements often contain provisions designed to facilitate the transfer of ownership interests under specified circumstances. Such provisions typically define the terms under which the ownership interest of a departing shareholder, member, or partner is redeemed, or purchased, including describing how value—that is, the purchase price—will be determined. Unfortunately, the definition of value provided in many corporate documents lacks the specificity required to address the circumstances that have the potential to exert significant impact on value, often resulting in extended, acrimonious, and expensive litigation. Therefore, a clear definition of value in ownership agreements is important.

Introduction

Ownership agreements are an important tool used to define a closely held business owners' rights and obligations, and ultimately to protect the interests of the owners. Ownership agreements may take many forms, including the following:

1. Bylaws
2. Buy-sell agreements
3. Shareholder agreements
4. Operating agreements
5. Partnership agreements.

In this discussion, we will use the term "ownership agreement" to refer to any type of ownership agreement that regulates the transfer or sale of ownership interests.

When drafting an ownership agreement, owners may incorporate one of any number of mechanisms for the purpose of determining price. These mechanisms include the following:

1. A fixed price
2. A price based on a formula
3. A price based on a specific valuation process
4. A valuation to be conducted by a qualified valuation analyst

However, owners often overlook the specifics concerning the definition of "value" to be applied in each of these scenarios.

Many ownership agreements do not provide a specific definition of "value," leaving the concept open to disagreement due to the resulting ambiguity. Instead, some ownership agreements use vague terms such as "market value" or "appraised value" to represent the price at which a selling owner will be redeemed.

When "value" is not clearly defined in an ownership agreement, the result is often a dispute between the terminating, or selling, owner and the continuing owner(s). In some cases this may lead to an extended litigation process. This is one reason why it is helpful to clearly define "value" as it pertains to the price at which an owner's interest will be redeemed at the time of a triggering event.

The definition attributed to "value" has the potential to positively affect either the selling owner or the remaining owner(s), when in fact value is generally intended to result in a "fair" economic transfer to all parties.

For example, a selling owner who owns less than a controlling interest may benefit if "value" is defined as the selling owner's pro rata share in the enterprise value of the business, without any discounts for lack of control or for lack of marketability.

Alternatively, the remaining owner(s) may benefit if the definition of "value" requires the inclusion of a lack of control and lack of marketability discount when such considerations were never initially contemplated.

At the time an ownership agreement is drafted, owners, to their detriment, may (1) not consider the impact that different definitions of "value" can exert on price or (2) hope that the definition of "value" relied on will benefit them.

However, an owner's exit scenario—often contemplated to occur decades beyond the entity formation date—rarely is considered fully at the onset of a venture. Therefore, it is in the best interest of all owners to clearly define their intent in an ownership agreement, rather than assuming, or hoping for, the best.

This discussion will:

1. provide common "value" definitions, including the standard, premise, and level of value;
2. identify and address additional, relevant considerations when defining "value," including intent and historical precedent; and
3. provide excerpts from ownership that define "value" in different ways.

Defining "Value"

Value can be, and is, defined in a number of ways in ownership agreements. Three important concepts that must be addressed in order to appropriately and clearly define value are:

1. the standard of value,
2. the premise of value, and
3. the level of value.

Standard of Value

The standard of value is the type of value being sought. The standard of value is specific to the ownership interest, the buyer and seller, and the context in which the ownership interest is being valued. The standard of value influences, and sometimes compels, the approaches and methods used by a valuation analyst to value an entity.

Common standards of value include the following:

- Fair market value
- Investment value
- Intrinsic value
- Fair value (in the context of state legal matters)

Fair market value is defined as "the amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts."[1]

Fair market value generally is understood to represent consideration on a "cash-equivalent" basis.

Investment value is defined as "the specific value of goods or services to a particular investor (or class of investors) based on individual investment requirements. . . ."[2]

Investment value may differ from fair market value (from the perspective of a particular owner) for the following reasons:

1. Differences in estimates of future earning power
2. Differences in perception of the degree of risk and the required rate of return
3. Differences in financing costs and tax status
4. Synergies with other operations owned or controlled

Intrinsic or "fundamental" value is defined as "an analytical judgment of value based on the perceived characteristics inherent in the investment, not tempered by characteristics peculiar to any one investor, but rather, tempered by how these perceived characteristics are interpreted by one analyst versus another."[3]

Intrinsic value is considered to represent the "true" or "real" worth of an item based on an objective evaluation of available facts.

Fair value (in states that have adopted the Uniform Business Corporation Act) is often defined as "the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable."[4]

Fair value in terms of business valuation (and not necessarily financial reporting) is usually a legally created standard of value that applies to certain specific transactions.

In most states, fair value is the statutory standard of value applicable in cases of dissenting stockholder appraisal rights.

Premise of Value

The premise of value reflects the actual set of hypothetical transactional circumstances applicable to an ownership interest. Much like the standard of value, the premise of value is specific to the ownership interest, the buyer and seller, and the context in which the ownership interest is being valued.

The premise of value may also influence the approaches and methods relied on by a valuation analyst to value an entity.

The premise of value can be classified in the following ways:

- Value as a going concern
- Value as an assemblage of assets
- Value as an orderly disposition
- Value as a forced liquidation

Value as a going concern is defined as "value in continued use, as a mass assemblage of income-producing assets, and as a going-concern business enterprise."[5]

The going-concern premise of value typically is used in business valuations where the subject company is expected to continue operating into the foreseeable future. The going-concern premise of value may be especially relevant to (1) entities with significant intangible value and (2) noncontrolling ownership interests with no ability to cause the sale or liquidation of assets.

Value as an assemblage of assets is defined as "value in place, as part of a mass assemblage of assets, but not in current use in the production of income, and not as a going-concern business enterprise."[6]

Value as an orderly disposition is defined as "value in exchange, on a piecemeal basis (not part of a mass-assemblage of assets), as part of an orderly disposition; this premise contemplates that all of the assets of the business enterprise will be sold individually, and that they will enjoy normal exposure to their appropriate secondary market."[7]

Value as a forced liquidation is defined as "value in exchange, on a piecemeal basis (not part of a mass assemblage of assets), as part of a forced liquidation; this premise contemplates that the assets of the business enterprise will be sold individually and that they will experience less than normal exposure to their appropriate secondary market."[8]

Level of Value

The level of value reflects characteristics of ownership, such as controlling versus noncontrolling ownership status, and the liquidity, or lack thereof, inherent in the ownership interest. Applicable valuation adjustments—for example, discounts or premiums—related to the level of value are ownership level adjustments that may apply to a specific ownership interest.

"Value" sections in ownership agreements should be clear regarding references to the permissibility or impermissibility of discounts or premiums related to the level of value for a specific ownership interest.

The level of value can be classified in the following ways:

- Synergistic level of value (i.e., value assuming a strategic buyer)
- Controlling level of value (i.e., value assuming a controlling buyer)
- Noncontrolling, marketable level of value (i.e., value assuming a noncontrolling ownership interest that is readily marketable or easily converted to cash)
- Noncontrolling, nonmarketable level of value (i.e., value assuming a noncontrolling ownership interest in a nonpublic company)

The level of value for an ownership interest subject to analysis may affect the methods an analyst relies on to value the subject company, as well as how the methods are applied. For example, an analyst typically would not consider a net asset value (e.g., liquidation-based) approach when the level of value for a particular ownership interest is defined as noncontrolling.

Similarly, an analyst may make adjustments to historical and projected earnings if the defined level of value for a particular ownership interest is controlling, and a hypothetical, controlling buyer would have the ability to cause such changes.

The level of value may influence the discounts and premiums applied to the subject ownership interest. Such discounts and premiums may be significant and may account for over 50 percent of the equity value in some scenarios.

Identifying the appropriate level of value can be confusing and challenging for owners, especially when there are varying rights among ownership interests and varying sizes of ownership interests. If the applicable level of value is not defined or described clearly in an ownership agreement, conflicts likely may arise between interested parties at the time of a triggering event or buy-out.

Intent and Historical Transactions

Relevant provisions of ownership agreements generally are understood to address the question regarding the "value" of ownership interests from the perspective of those forming/participating in the subject business. The initial formation of an entity typically contemplates the potential departure of owners prior to the expiration or dissolution of the entity.

Historical practice suggests that "value" typically is contemplated from an equity perspective (i.e., "fairness"). As the terms of an ownership agreement typically are negotiated and agreed upon by the parties covered by the agreement, it stands to reason that at least an attempt was made to incorporate terms that all parties believed were fair and reasonable at the time the agreement was developed.

Valuation analysts typically address the question of owner "intent" based primarily on consideration of observable, historical practice with regard to the implementation of a particular ownership agreement. Clearly, legal interpretation may be warranted.

Generally accepted valuation practice (for example, Revenue Ruling 59-60 issued by the Internal Revenue Service) suggests consideration of historical transactions in a company's equity when estimating fair market value.

Timely, historical transactions in a company's equity—in circumstances determined to be arm's-length—provide relevant information that reasonably can be considered when estimating the value of the equity of a company for redemption purposes.

A history of transactions in the equity of an entity often serves to neutralize "value" terms within an ownership agreement if "value" was defined or established in an inconsistent manner.

Historical transactions may be a key consideration when examining the intent of owners regarding the definition of "value" included in an ownership agreement. The analysis of historical transactions can provide insights with regard to owner intent relating to "value."

Further, historical transactions may also influence court decisions when there is a dispute over the applicable definition of "value."

For example, in *Estate of Maurice F. Frink v. Flowerama of America, Inc.*,[9] the estate argued that fair market value should be used as the relevant standard of value. The company argued that accounting book value was the applicable standard of value because it was defined in the subject ownership agreement as such.

In its decision, the court noted that **past redemptions** were made at book value and ultimately decided in favor of using book value as the price at which the estate was redeemed.

Past transactions, occurring at arm's length, allow disputing owners, or a court, to objectively analyze what definition of "value" may be most appropriate in a certain circumstance.

If prior arm's-length transactions have occurred under a certain standard, premise, and level of value, this adds validity to an owner's claim that such definition of "value" is unbiased and relevant to apply in an ownership redemption occurring under similar circumstances.

Examples of "Value" Definitions in Actual Ownership Agreements

This section presents examples of different definitions of "value" included in actual ownership agreements.

Example 1

> The option will be exercisable for an amount ("option price") equal to the product of (1) the **fair market value** of the company as a **going concern** taking into account the company's assets and the then-outstanding obligations of the company, including any unpaid balance of the preformation indebtedness, on the date of the triggering event; (2) the decimal equivalent of the percentage interest represented by the interest subject to option; and (3) the decimal equivalent of 60%. The 60% factor in the foregoing formula is intended to subject the product determined under clauses (1) and (2) to a 40% **discount to take into account a reasonable discount for lack of marketability and for noncontrolling ownership interest**. This 40% discount has been arrived at through arm's-length negotiation among the parties and, accordingly, is and will be deemed fair and reasonable under the circumstances.

This ownership agreement excerpt specifies "value" from three perspectives. The standard of value is clearly defined as "fair market value." The premise of value is clearly defined as "going concern."

Additionally, this agreement clearly states that the level of value will be noncontrolling and nonmarketable. The agreement even goes so far as to define the exact level of discounts for lack of control and for lack of marketability considerations, in theory removing the decision from the hands of potential disputing parties and their valuation analysts.

The unique aspect of this ownership agreement is the predetermination of a level of discount to apply to the subject ownership interest. This tactic aims to remove some of the ambiguity, and, therefore, potential conflict between buyer and seller, regarding the appropriate level of combined discounts for lack of marketability and for lack of control.

Although the subject ownership agreement clearly states the definition of "value" based on the three key considerations previously discussed (i.e., the standard of value, premise of value, and level of value), room still exists for potential disagreement.

The company (i.e., the buyer) may argue that "fair market value" should be determined from the perspective of a noncontrolling owner prior to the application of the predetermined 40 percent discount.

This could include incorporating a noncontrolling level cash flow in the income approach and discounts to any market multiples derived from the analysis of controlling-interest transactions for the purpose of completing the market approach (i.e., the guideline transactions method).

The party exercising the option (i.e., the selling owner) may argue that "fair market value" should be determined from the perspective of a controlling owner. This could include incorporating a higher level of cash flow from the perspective of a controlling owner in the income approach and the application of premiums to market multiples derived from the analysis of noncontrolling, publicly traded interests for the purpose of completing the market approach (i.e., the guideline publicly traded company method). The justification being that a discount for lack of control is warranted only to the extent that a corollary control premium is incorporated in the initial fair market value conclusion.

The validity of each of these arguments may increase or decrease depending on the (1) size of the ownership interest subject to option or (2) rights and benefits inherent in the ownership interest subject to option.

If the size of the ownership interest subject to option approaches 50 percent, or if the subject ownership interest affords the owner significant attributes of control, an argument could be made for a control level of value (prior to the predetermined 40 percent discount).

If the selling owner is indeed a noncontrolling owner by all accounts (i.e., unable to exert any influence on the operations of the subject company), an argument could still be made that an excessive level of discount for lack of control has been incorporated in the option price based on (1) a claim that the pre-discounted fair market value inappropriately excludes any level of control premium, and (2) the basis for, and form of, the predetermined 40 percent combined discount (i.e., such a discount may be relevant and reasonable at a point in time, but nor over all time, particularly as it relates to the portions allocable to lack of control and lack of marketability).

The subject ownership agreement goes on to read as follows:

> In any case in which the company acting through the board of directors and the optionor (each a "party") are unable to agree upon the fair market value of the company as a going concern (taking into account the company's assets and then then-outstanding obligations of the company, including any unpaid balance of the preformation indebtedness) within the 30-day period for such agreement under Section 2.6(b), each shall give a notice to the other appointing an appraiser.

Although this agreement goes to great lengths to define "value," ultimately there may be a significant divide between different valuation analyst's interpretations of "fair market value" given the circumstance of a mandatory 40 percent discount.

Example 2

> The value of the affected shareholder's ownership interests will be determined by multiplying the shareholder's percentage ownership interest by the fair market value of the company (**the amount that could reasonably be expected to be realized upon sale**) net of liabilities of all company assets, with appropriate discount for a noncontrolling interest or lack of marketability. Provided, however, in the event the triggering event is the death of a shareholder as provided in Section 9.6 above, the value of the deceased shareholder's ownership interest will **not include any discount for a noncontrolling interest or lack of marketability**.
>
> The fair market value of the company assets will be determined by agreement between a majority in interest of the

remaining shareholders holding all shares (voting and nonvoting) and the affected shareholder or the affected shareholder's successor. In the event an agreement as to the value cannot be obtained, the fair market value of the company's assets will be determined by a valuation. The company will first select a valuation analyst who will value the company's assets.

The affected shareholder or the affected shareholder's successor may elect, either before or after the company has submitted a report, to select another valuation analyst.

In the event the two appraisers fail to reach agreement on the fair market value of the company's assets, the two valuation analysts will mutually select a third appraiser whose determination of the value of the company's assets will be binding on the company and the affected shareholder or the affected shareholder's successor.

The subject ownership agreement excerpt defines the standard of value as the "fair market value of the company." The subject ownership agreement goes on to clarify the specific basis for establishing fair market value as "the amount that could reasonably be expected to be realized upon sale" (of the entire company).

The subject ownership agreement also specifies when discounts for lack of control and lack of marketability should be considered, and when such discounts should be ignored.

This ownership agreement is unique in that the level of value differs based not on the size or attributes of the subject ownership interest, but rather on the circumstance under which the owner withdraws (i.e., voluntarily versus upon death).

Although the standard of value is clearly defined, the ownership agreement leaves some ambiguity with regard to the premise of value. The subject ownership agreement states that the fair market value of the company is "the amount that could reasonably be expected to be realized upon sale." It is not clear whether the hypothetical sale would reflect:

1. value as a going concern or
2. value in liquidation (if appropriate).

If the company's net asset value exceeds its value as a going concern, a legitimate question may arise regarding the appropriate premise of value to consider. The subject ownership agreement states the fair market value of the company, not the subject interest, is the starting point for the determination of "value."

However, if the subject interest is a noncontrolling ownership interest, then is the "value" of the individual assets relevant? If so, is the "reasonable sale price" based on forced liquidation, or should the "reasonable sale price" reflect an orderly disposition?

Qualifying the level of value to be used based on the nature of the triggering event may also lead to disagreement between the selling owner and the remaining owner(s). If a sale is triggered due to disability or another unavoidable event, should a discount for lack of control and a discount for lack of marketability still be applied?

Example 3

The definition of "value" incorporated in an ownership agreement may be used as a tool—advertently or inadvertently— to:

1. benefit the seller of an ownership interest (i.e., no allowable discounts),
2. benefit the buyer of an ownership interest (i.e., mandatory discounts), or
3. discourage the sale or transfer of ownership interests.

The following excerpt from an ownership agreement illustrates how the definition of "value" can be used to discourage certain types of transfers and benefit the remaining owner(s) (i.e., buyers).

In the event any shareholder's shares are involuntarily transferred to any nonshareholder person or entity, without written consent of the other shareholders of the corporation, the transferee will be obligated to sell, and the corporation will have the right to purchase, all or a portion of the involuntary transferred shares. This provision will not apply to a transfer by a shareholder to a revocable trust controlled by the shareholder, nor a transfer by operation of law on the shareholder's death.

Under this paragraph, the purchase price will be determined by the following formula:

- The value of the assets of the corporation will be determined at **book value, without any weight given to going-concern value or goodwill, and taking into consideration any accumulated depreciation** ("asset value").

- The total amount of current and long-term liabilities will then be deducted from the asset value, resulting in a "net asset value."
- Net asset value will then be **reduced by 50%**, and from this figure, the pro rata value of the involuntarily transferred shares ("purchase price") will be determined.

In this example, the formula for determining "value" is defined. It is also clear that the definition of "value" as described in this example is used as a tool to discourage involuntary transfers of ownership interests.

There have been multiple court cases that have supported the use of book value to determine a purchase price, even if that value differs significantly from the fair value or fair market value of the subject ownership interest.

One deciding factor in these court cases was that the definition of "value" is clearly defined in the subject ownership agreement as book value.

This was the case in (1) *Estate of Maurice F. Frink v. Flowerama of America, Inc.*;[10] (2) *Tynes E. Mixon, III, M.D., v. Iberia Surgical LLC*;[11] and (3) *Estate of Cohen v. Booth Computers and James S. Cohen*.[12] In each of these court cases, the court upheld that book value was the appropriate definition of "value" to use in determining price, even though the resulting price was significantly lower than if calculated on a fair market value basis.

In each of these cases, the court cited a clearly defined standard of value (book value) in the subject ownership agreement as a reason for its decision.

Example 3 and the court cases cited above illustrate how defining "value" can be used by founding owners to serve a specific interest that otherwise may not be appropriate or defensible under generally accepted valuation practices.

Conclusions

Founding owners of an entity are free to define "value" in any legal manner desired. The definition of "value" incorporated in an ownership agreement, if not appropriately considered and structured, may inadvertently benefit the seller of an ownership interest to the detriment of the buyer, or inadvertently benefit the buyer of an ownership interest to the detriment of the seller.

As noted in example 3, the founding owners of an entity may even use the definition of "value" to discourage or encourage certain types of sales.

The definition of "value" incorporated in an ownership agreement should reflect the long-term intent of the founding owners. However, the founding owners drafting the ownership agreement may consider the likelihood that they ultimately may leave and new owners may join.

Founding owners should also keep in mind that unless specifically defined, the term "fair market value," when left to qualified valuation analysts, will be estimated based on consideration of generally accepted valuation practice, as influenced by the facts and circumstances unique to the transaction under consideration.

"The definition of 'value' incorporated in an ownership agreement, . . . may inadvertently benefit the seller of an ownership interest to the detriment of the buyer, or inadvertently benefit the buyer of an ownership interest to the detriment of the seller."

In order for owners to maintain control over transactions and realize their intent, it is important that an ownership agreement clearly defines "value" in all key respects, including:

1. the standard of value,
2. the premise of value, and
3. the level of value.

Further, clarity in an ownership agreement may be enhanced if it gives illustrative examples regarding how the definition of "value" is intended to be applied.

As presented in examples 1 and 2, even when the definition of "value" is well thought out and defined, there is still room for interpretation, and, therefore, potential dispute.

As external (e.g., economic and industry) and internal (e.g., aging owners and changing employees) circumstances evolve and change, the need for potential modifications to definitions and interpretations of "value" may develop, regardless of diligence and thought incorporated in an original ownership agreement.

Dissenting owners can argue the intent, or original definition of "value" incorporated in an ownership agreement, is no longer relevant or fair based on a change in circumstances.

One useful method to minimize the potential for conflict relating to the buyout provision in an ownership agreement is to engage a qualified, independent advisory team—represented by a valuation analyst and legal counsel—to analyze owner intent and complete a valuation based on a clearly stated definition of "value."

Completing such a process prior to the development of an ownership agreement (or redemption) may provide valuable information for the parties that should better enable them to reflect their intentions in the agreement and adhere to consistent redemption practices after the consummation of the agreement.

By preemptively performing a valuation, the owners and interested parties can provide input prior to conflicts of interest clouding the debate. The valuation process can then be repeated in a consistent manner at defined intervals, minimizing the potential for dispute at the time a triggering event occurs.

Notes:

1. American Society of Appraisers, Business Valuation Standards – Definitions.
2. *The Appraisal of Real Estate*, 11th ed. (Chicago: Appraisal Institute, 1996), 638.
3. Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business*, 4th ed. (New York: McGraw-Hill, 2000), 31.
4. Model Business Corporation Act § 13.01(3)(ABA 1984).
5. Pratt, Reilly, and Schweihs, *Valuing a Business*, 33.
6. Ibid.
7. Ibid.
8. Ibid.
9. Estate of Maurice F. Frink v. Regions Bank, et al., 725 N.W.2d 658 (Iowa Ct. App. 2006).
10. Ibid.
11. Mixon v. Iberia Surgical, L.L.C., 956 So.2d 76 (La. Ct. App. 2007).
12. Estate of Cohen, ex. rel. Perelman v. Booth Computers, 22 A.3d 991 (N.J. Super. Ct. App. Div. 2011).

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Entity-Level vs. Ownership-Level

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As a result, in a fair value context for a dissenter case, it may be necessary to identify whether including or excluding a conglomerate discount is likely to unjustly benefit one party or the other. Ideally, the ultimate value impact on all parties should be equitable.

Conclusion

The fair value standard in a dissenter case often presents a number of valuation considerations specific to the engagement that are not necessarily present in a "standard" valuation engagement.

First, it is important to understand the relevant state statute and court precedents that may affect the current engagement.

Second, it may be necessary to recognize potential valuation adjustments as entity-level or ownership-level adjustments, and then identify whether the inclusion of an adjustment is appropriate based on the applicable fair value definition and the facts and circumstances of the particular engagement.

Third, it is important to understand that certain entity-level discounts may be appropriate under a fair value standard and to properly apply the necessary methods to quantify a reasonable valuation adjustment.

Finally, consideration may be given to analysis of the concluded results from both a dissenting shareholder and a nondissenting shareholder perspective in order to establish the reasonableness of economic returns afforded to both parties.

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