

# Valuation Issues to Consider for Large Block Minority Shareholder Redemptions

Jeffrey S. Burns and Nathan P. Novak

*The purpose of this discussion is to identify certain issues to consider when performing a valuation analysis for the purpose of a closely held company shareholder redemption. Specifically, the focus of this discussion is on certain qualitative and quantitative factors that commonly arise when a closely held company is going through the process of redeeming or buying out an ownership interest of a significantly large but noncontrolling shareholder.*

*Several considerations that are unique to large block noncontrolling shareholder redemptions are discussed below. Additionally, an example is provided to illustrate how certain of the issues can occur and can be handled in a hypothetical, but realistic, situation.*

## INTRODUCTION

A shareholder redemption, as that term is used throughout this discussion, occurs when a shareholder (or otherwise owner) of a company sells his or her shares back to the company. The shares may be retired or may be distributed among the remaining shareholders.

Ultimately, the result is the same either way:

1. There will be one less shareholder.
2. The remaining shareholders will own proportionately more of the company.
3. The overall value of the remaining shareholders' interests should be unaffected by the redemption.<sup>1</sup>

That is, in an equitable shareholder redemption, neither the redeemed shareholder nor the remaining shareholders should gain or lose wealth from the transaction.

There are several situations that can give rise to a shareholder redemption. A shareholder redemption can be mutual, such as if a shareholder wishes to sell his or her shares and the company agrees to buy them so as to avoid the presence of a new shareholder. Or, a shareholder redemption can be forced,

such as if a shareholder claims he or she is being oppressed by the company and a court orders that company to redeem the oppressed shareholder's shares.

This discussion focuses on the valuation issues that arise during a litigious shareholder redemption, such as the issues related to the dissociation of an owner. Further, there are certain issues that are unique to the redemption of a noncontrolling shareholder that holds a significantly large block of the company stock.

## ISSUES TO CONSIDER

There are certain general issues that commonly occur when a large block noncontrolling shareholder has his or her shares redeemed.

First and foremost, relevant statutes or judicial decisions should be considered, especially if the redemption is the product of litigation proceedings. Additionally, there are often key person risks that should be considered.

There are also a number of issues related to how the company will fund the shareholder redemption and the effect that it will have on the company going forward.

---

**“ . . . there are diverse legal issues that need to be considered depending on the context of the shareholder redemption or buy-out.”**

---

## Legal Issues

The laws that govern relations between business owners vary depending on the jurisdiction and type of business that is owned. State laws on owner's rights differ from state to state and, similarly, the federal laws differ from the state laws.

Additionally, the laws that govern partnerships are often separate from the laws that govern limited liability companies or corporations.

Since a stock redemption can be effectuated through litigation, the relevant statutes can have a significant impact on the appropriate considerations when valuing a company for purposes of a stock redemption. Again, these statutes vary from state to state.

An article authored by Sandra K. Miller from the Spring 2011 issue of the *University of Pennsylvania Journal of Business Law* helps illustrate this point specifically in the context of limited liability company (LLC) member dispute when one member wishes to “get out” of the business.

The Revised Uniform Limited Liability Act authorizes judicial dissolution for illegal, fraudulent, or oppressive conduct, but fails to offer provisions for a buy-out in lieu of a dissolution or any related valuation guidelines. In contrast, approximately twenty-two corporate statutes provide for a purchase in lieu of a judicial dissolution pursuant to the Model Business Corporation Act.<sup>2</sup>

And further in contrast:

[T]he Delaware LLC statute authorizes judicial dissolution on the ground that it is not reasonably practicable to carry on business . . . [and] the Illinois LLC statute contains a buy-out provision in lieu of dissolution and specifies that the valuation is to be based on “fair value.”<sup>3</sup>

Finally:

California and Utah authorize a buy-out in lieu of dissolution and specify that the valuation should be with reference to “fair market value.”<sup>4</sup>

Further, there are statutes that specify general valuation guidelines upon the dissociation of a partner from a partnership. Section 701 of the Revised Uniform Partnership Act states,

[T]he buyout price of a dissociated partner's interest is the amount that would have been distributable to the dissociating partner . . . if, on the date of dissociation, the assets of the partnership were sold at a price equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern without the dissociated partner.<sup>5</sup>

Clearly, there are diverse legal issues that need to be considered depending on the context of the shareholder redemption or buy-out. Certain states, such as Illinois, specify the use of fair value when valuing shares for the purpose of a forced LLC shareholder buy-out. Other states, such as California and Utah, specify the use of fair market value for purposes of a buy-out whereas other states are silent on the appropriate standard of value.

Similarly, certain states prefer the use of a judicial dissolution of a business rather than a buy-out or redemption of a disassociated owner.

Ultimately, the take-away is that because statutes governing the redemption process differ significantly depending on the facts of a case, it is important to seek legal advice as a first step in order to determine which statutes or judicial precedent should be considered in a valuation for purposes of a stock redemption.

And, although the statutes and judicial precedents differ between jurisdictions, the overarching theme is that, upon an event that would necessitate a shareholder redemption in some form, the courts appear to want what is most equitable for both the departing owner as well as the remaining owner(s).

## Key Person Risk

It is often the case that large shareholders of a privately held company are heavily involved with the operations of the company. This is especially true for smaller companies or for companies that are in the early stages of operations.

Those types of companies may be subject to significant key person dependency. Key person dependence exists when the performance of the company is highly dependent on one or a few key individuals, and the loss of any such individuals would materially impact the future success of the company.

The presence of a “key person” or key person risk is relevant when valuing a company for the purpose of a shareholder redemption. If the shareholder to be redeemed could be classified as a key person within the company, then the future financial performance of the company could potentially look very different after that individual shareholder has left the company.

As discussed above, the Revised Uniform Partnership Act specifically states that a buyout price may be based on a sale of the entire business *without the dissociated partner*.

Accordingly, since a shareholder redemption inherently involves the departure of the redeemed shareholder, the purchase price of the shares should be analyzed based on projected company performance in the absence of said shareholder.

Sandra Miller provides further guidance in her article, which states:

[T]here may be unusual cases where a withdrawing LLC member may take goodwill and/or other intellectual property with him. In such instances, the buy-out price paid to the withdrawing LLC member might be grossly unfair and overstated without considering the value of the intellectual and/or intangible value withdrawn by the dissociating LLC member himself. The Comments to the Revised Uniform Partnership Act appear to recognize the possibility of discounts other than a minority interest discount and mention the key person discount.<sup>6</sup>

One way to capture the effects that a key person has on company value is to create a set of financial projections that directly removes any and all contributions by the key person. For example, consider a shareholder of a closely held company who is being redeemed and who is responsible for maintaining half of the company’s customer relationships.

The customers for which the departing key person is responsible can be identified and certain assumptions could be made about which of these customers will stop doing business with the company due to the departure of that individual. A set of projections could be created that remove sales (and related costs) generated from the departing customers.

Other considerations can be made to include the removal of future compensation for the departing shareholder or the expense related to hiring a replacement. Ultimately, a set of projections that capture the effects of the loss of the key person can be used to accurately estimate the value of the com-

pany after the loss of the redeemed shareholder.

Another way to estimate the value of a key person is to investigate whether or not the company holds any insurance policies for the individual (or other individuals with similar functions within the company).

If a company holds an insurance policy on the redeeming shareholder, the face value of that policy may provide an estimate of the value that the company places on the contributions of that individual.

The face value of the insurance policy can be subtracted from the enterprise value of the company in order to reflect the loss in value due to the departure of the individual.

Finally, there may not be a direct way to quantify the effects that a loss of a key individual will have on a company. It may not be possible to create a set of financial projections that exclude the individual and the company may not hold any insurance policies on the key person.

When all else fails, it may be appropriate to capture the effect of the key person dependency through a more judgment-based valuation analyst adjustment.

The key person risk can be captured in an income approach through an adjustment to the present value discount rate. Similarly, the key person risk can be captured in a market approach by making an adjustment to the selected pricing multiples to account for the loss of the key individual. We note that these more indirect methods are generally more judgment-based and may be subject to scrutiny. Such methods should be supported, to the extent possible, with direct evidence.

Ultimately, although the issue of key person dependency is not unique to a shareholder redemption analysis, it is certainly common when a company fully redeems the shares of a large shareholder. It may be considered as the facts dictate or else the concluded value for the redeemed shares may be significantly overstated.

---

**“ . . . key person risk is relevant when valuing a company for the purpose of a full shareholder redemption.”**

---

## Funding Issues

Inherent in any shareholder buyout or redemption is the need to gather enough funds to pay the departing shareholder for his shares. Not surprisingly, this issue becomes increasingly important as the block size of the departing owner’s interest increases in size.

As stated in the second court of appeal's opinion for *Jerry Rappaport v. Marvin Gelfand*, "Under the UPA, if there is a dissociation of a partner . . . the remaining partners have a right to continue the business and the dissociated partner has a right to be paid the buyout price of his or her partnership interest."<sup>7</sup>

Accordingly, since the remaining partners have a right to continue the business, it stands to reason that the buyout price of the departing partner should not be so great as to adversely affect the future operations of the business.

It is sometimes the case that a company will not have sufficient cash to purchase a block of stock that comprises a significant percentage of the outstanding shares. Accordingly, it may be necessary for the company to seek financing through the issuance of debt or equity.

Although the issue of financing for the purpose of a buyout is not often directly considered in a valuation analysis, it should not simply be ignored. As discussed above, since the purpose of a buyout is often not to dissolve the company, valuations for purposes of a buyout are often performed on a going-concern basis.

The buyout price and subsequent funding should not significantly burden the company to the point of failure. Therefore, the issues of the buyout price and access to financing in the context of the redemption are intertwined and should be considered against one another.

For purposes of a shareholder redemption, a company will typically seek financing through debt (i.e. a bank loan, issuance of bonds, etc.). Of course, the first consideration is whether or not the company will be able to secure enough financing to fund a significantly large buyout.

From a lender standpoint, one consideration is whether or not the company has sufficient cash flow to make interest and principal payments on its debt. For example, consider a company that has limited cash flow projected for the next several years due to significant planned capital expenditures. It may be the case that the company simply would not have cash flow available to both satisfy significant debt service payments and also make the planned capital expenditures.

Further, if a company already has debt outstanding, there may be restrictive covenants that prevent it from borrowing a large enough amount to fund a buyout. Ultimately, it may be the case that certain factors prevent the company from realistically borrowing enough funds at a given buyout price.

In the prior example, if a company has to select between making capital expenditures and securing

debt, it begs the question of how does such a determination affect the value of the business?

Clearly, if a redemption causes the projected future cash flow of a company to materially change (as opposed to the projected cash flow in the absence of a redemption), then that may be a consideration in determining the buyout price of the shares.

The issue of financing a buyout or redemption may ultimately be used as a reality check against the concluded buyout price.

If the price is so high that the projected company cash flow simply does not allow it to reasonably secure enough financing at the given value, it may be the case that certain assumptions or risk factors should be revisited.

Ultimately, the act of securing financing should not be so burdensome that it materially adversely affects the future performance of the company. If this is the case, the intention of valuing the business under the assumption that the remaining shareholders have a "right to continue the business" may be violated.

## AN ILLUSTRATIVE EXAMPLE

In order to better explain some of the points described above, we present an example of some factors that an analyst may consider when developing his or her value conclusion.

This is not intended to be a comprehensive example, but is rather an example of certain things which would likely be discussed throughout a valuation report, such as valuation variables, conclusions, and background information.

Let's assume that Tom, a valuation analyst with Business Valuation, Inc., was retained by legal counsel to provide his opinion of value of a 50 percent membership interest in ProCamps, LLC ("ProCamps").

The case relates to a dispute in which Tony, a 50 percent member of ProCamps, a California privately held limited liability corporation, is attempting to buy out the remaining 50 percent member, Jim, and there is disagreement on the value of the company.

The following discussion describes some of the significant issues that Tom discussed in his valuation report.

### Company Background

1. ProCamps began offering youth hockey camps five years ago. It has short-term contracts with 20 of the 30 professional hockey teams in the National Hockey League (NHL).

The camps are held in locations nearest the contracted NHL teams.

On the final day of camp, the contracted team will send one of their current NHL players to make an appearance at the camp, sign autographs, and provide additional instruction.

2. Tony and Jim, the two members of ProCamps, are former professional hockey players. Tony spent his entire career playing for NHL teams in the western conference and, in turn, has personal relationships with several western conference NHL teams.

Similarly, Jim spent his entire career playing for NHL teams in the eastern conference and maintains relationships with several eastern conference teams.

Additionally, Tony's brother, a successful real estate investor, owns 6 of the 20 hockey rinks where ProCamps conducts its camps.

3. The ProCamps revenue has grown rapidly, and in the latest 12 months, ProCamps has revenue of \$40 million and has operating income of \$1 million. This is the first year ProCamps earned a profit. ProCamps expects minimal revenue growth, but expects profit margins to increase each year.
4. ProCamps owns very few tangible assets but has significant intangible value.
5. ProCamps currently has revolving debt with a limit of \$5 million.

## Valuation Analysis and Valuation Variables

1. Tom used an income approach and, specifically, the discounted cash flow valuation method.
2. In his income approach analysis, Tom created a five-year discounted cash flow model based on financial projections that were provided to him by ProCamps management.
3. Tom estimated the ProCamps weighted average cost of capital to be 15 percent. This was based on a weighting of ProCamps capital structure of approximately 5 percent debt and 95 percent equity.

The ProCamps estimated cost of equity was 16 percent, which included a company-specific equity risk premium (CSRP) of 1 percent.

Tom explained the CSRP to account for the key person risk inherent in ProCamps business.



4. Tom concluded a marketable, controlling interest value for a 50 percent membership interest in ProCamps to be \$25 million.

## Additional Consideration

Tom may have overlooked many issues that are relevant to this analysis including the following:

1. Legal issues
2. Key person risk
3. Funding issues

### Legal Issues

The concluded value of \$25 million assumes that the equity capital of ProCamps is as liquid—or as readily marketable—as publicly traded securities. Tom incorrectly did not apply a discount for lack of marketability.

Tom failed to realize that California statute specifies the valuation should be on a fair market value basis, as discussed previously. In this case, appropriate valuation discounts may have been applied. Failing to apply valuation discounts may result in an overvaluation of Jim's 50 percent membership interest in ProCamps.

### Key Person Risk

Although Tom applied a 1 percent CSRP and suggested that it accounted for key person risk, he most likely underestimated this risk. It is clear that ProCamps has certain company-specific risk factors, including the following:

1. Key person dependence
2. The risk of losing contracts with NHL teams

ProCamps appeals to youth camp participants because of its affiliations with NHL teams and their players. ProCamps has been successful in growing its business due to Tony's and Jim's personal relationships they each developed during their careers in the NHL. Because of these relationships, they were able to secure short-term contracts with several NHL teams.

Without Tony's and Jim's personal relationships, ProCamps might not be affiliated with these NHL teams, and in turn, ProCamps might experience a large decrease in camp enrollment. This example illustrates the key person risk that may be inherent in the ProCamps business.

Additionally, ProCamps has negotiated favorable contracts with several of the ice rinks where ProCamps conducts its camps. Tony's brother allows ProCamps to hold camps at his ice rinks at a significant discount to the usual user fee. Tony has indicated that, because of the reduction in costs, ProCamps is able to operate at higher margins than normal.

Losing out on these favorable contracts might negatively affect ProCamps business. The possibility of losing out on these favorable contracts is an additional risk to ProCamps business.

Based on these identified risks specific to the ProCamps business, it may be appropriate to add an additional CSRP to ProCamps cost of equity capital to account for these risks. It is up to the valuation analyst to properly estimate the effect these risks have on the specific business and apply an appropriate CSRP that accounts for these risks.

Alternatively, Tom could have adjusted the company financial projections to account for the absence of Jim. Of these two methods, one is not necessarily superior to the other. The analyst may decide which method would result in a more accurate estimation of value subsequent to the departure of the key person.

## Funding Issues

Tom failed to consider the implication that his \$25 million buyout price would have on ProCamps business. The price that is to be paid to a redeeming member for his membership interest should not force the liquidation of the business. Forcing ProCamps to pay \$25 million may affect its ability to operate as a going concern.

ProCamps has very little cash available, and therefore, it would have to borrow a significant portion of the \$25 million buyout price. As mentioned above, ProCamps had a credit limit of \$5 million on its revolving debt.

It may be fair to assume that no bank would be willing to provide ProCamps a \$25 million long-term loan. Even if ProCamps was somehow able to obtain debt financing of \$25 million, principal and interest

payments on this loan would have an impact on the future cash flow of ProCamps.

The point to make here is that when reaching the value conclusion, the valuation analyst should consider (1) whether the company has the ability to obtain financing in the amount of the buyout price and (2) whether servicing the debt would affect the company's ability to operate as a going concern.

## SUMMARY AND CONCLUSION

As discussed above, several issues may have a significant impact on the concluded value that is used in a shareholder redemption transaction. The issues outlined above are just a few of the issues to consider when valuing a large block of shares for purposes of a redemption.

The issues described above are by no means exhaustive, but there are a few issues that may go unnoticed by a valuation analyst.

In general, when developing a value conclusion for a large share block redemption, a valuation analyst may consider the following:

- Any legal issues applicable to the subject entity's specific jurisdiction
- If there is any key person risk inherent with company management, particularly with the departing shareholder
- If it is feasible for the company to fund a share redemption based on the concluded value

### Notes:

1. We note that the shareholder redemption process we refer to throughout this article contemplates a full redemption (i.e., the selling shareholder no longer holds any stake in the company).
2. Sandra K. Miller, "Discounts and Buyouts in Minority Investor LLC Valuation Disputes Involving Oppression or Divorce," *University of Pennsylvania Journal of Business Law* (Spring 2011): 5.
3. *Ibid.*: 5-6.
4. *Ibid.*: 6.
5. Rev. Uniform Partnership Act Section 701 (2014-2015 ed.), §701(b).
6. Miller, "Discounts and Buyouts": 16.
7. *Rappaport v. Gelfand*, 197 Cal.App.4th 1213 (2011), 5.

Jeffrey S. Burns and Nathan P. Novak are both associates in our Chicago practice office. Jeff can be reached at (773) 399-4338 or at [jsburns@willamette.com](mailto:jsburns@willamette.com). Nate can be reached at (773) 399-4325 or at [npnovak@willamette.com](mailto:npnovak@willamette.com).

