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INSIGHTS

THINKING AHEAD: ENSURING A SMOOTH VALUATION PROCESS IN SHAREHOLDERS' AGREEMENTS

by Jacob Martin, Mahnoor Kiani, and Kevin Thistle

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A strong shareholders agreement can help owners avoid costly legal disputes when it matters most.

When starting a business, there is often a mix of enthusiasm and fear among a company's founders. The desire to survive, thrive, and expand often overshadows attention to routine legal documents like shareholders' agreements.

This is especially true as it relates to the provisions in shareholders' agreements that address the eventual buyout of a shareholder's interest, including the valuation process. After all, why would you need to think about an exit plan when you've barely got your foot in the door?

Unfortunately, the absence of a well-defined process for a shareholder exit can lead to infighting, delays, and high legal costs before the value of a shareholder's interest is even determined. To avoid headaches down the road, there are several key decisions that should be made when drafting a shareholders' agreement to simplify and expedite the valuation and exit process.

Important Decisions for Owners

A well drafted shareholders' agreement does more than govern ownership. It helps prevent conflict during a shareholder exit by setting out clear processes for identifying triggering events, defining value, selecting valuators, setting the valuation date, and establishing fair payment terms. Thinking through these issues early can reduce uncertainty, avoid costly disputes, and help ensure a smoother transition when it matters most.

Is This a Triggering Event?

Valuation does not occur in a vacuum – it is typically triggered by a specific event.

Shareholders' agreements will typically include a list of "triggering events" that require a shareholder's interest to be valued and bought out. Common scenarios include retirement, death, matrimonial dissolution, insolvency, shareholder disputes, or voluntary exits. When drafting or reviewing a shareholders' agreement, it is important to consider whether all potential triggering events have been contemplated.

More importantly, shareholders should consider whether each of these events is intended to result in a mandatory buyout. Not every event must automatically lead to a valuation and exit. For example, should termination of employment automatically trigger a buyout in every case? Shareholders may wish to explicitly distinguish between events that require an immediate exit and those that do not.

What is “Value” Anyway?

Once a triggering event occurs, the first thing that will go through a departing shareholder’s mind is whether they are adequately compensated for the “value” of their shares. “Value” should be defined as explicitly as possible to avoid confusion down the road.

One option for determining “Value” is the use of a predefined formula, which offers simplicity and predictability for the shareholders. However, it often fails to capture the economic reality and true value of a business.

If third party valuators are to be engaged, but “Value” is poorly defined, the valuators may default to the definition of Fair Market Value contained within the International Valuation Glossary – Business Valuation. [1] However, this may not reflect the desire of the shareholders when the shareholders’ agreement is signed. For example, a valuation under Fair Market Value will often result in the interest of a minority shareholder being worth less than their pro-rata share of business value because of discounts for lack of control and lack of marketability. If the desire of the shareholders was that each of them would benefit proportionately from the growth of the business, “Value” within the shareholders’ agreement should explicitly exclude such discounts.

[1] CBV Practice Bulletin No. 2: International Valuation Glossary – Business Valuation.

How Many Valuators in the Kitchen and Who Are They?

If a formal valuation is to be conducted, another key consideration for the shareholders' agreement is whether each side will retain its own valuator or whether the parties will retain a single, jointly appointed valuator. Both approaches have their proponents and detractors, and the shareholders will ultimately have to weigh the pros and cons as they relate to timing, cost, and perceived fairness and accuracy.

Regardless of the approach selected, the agreement should establish minimum qualifications and independence standards when it comes to assigning a valuator. This may include requiring a Chartered Business Valuator (CBV) to perform the valuation. Equally important, the agreement should clearly define independence criteria to ensure that the selected valuator(s) is/are free from bias.

The choice of valuation date is not neutral. In volatile or high-growth businesses, even short periods of time can significantly impact value.

Value as of When?

One important detail that is commonly overlooked in the shareholders' agreement is the choice of a valuation date (i.e., a current valuation date, the date of the triggering event, or another specified date). The choice of valuation date is not neutral. In volatile or high-growth businesses, even short periods of time can significantly impact value.

If the valuation date is not clearly defined, disputes are likely to arise over whether subsequent events, improved performance, or unexpected setbacks should be reflected in the price for the departing shareholder's interest. By fixing the valuation date in advance, shareholders can reduce uncertainty, limit disagreement, and create a more predictable and efficient buyout process.

When Do I Get Paid?

Once value has been determined, the shareholders' agreement should clearly outline how value is remitted to the exiting shareholder. Specifically, is the payment immediate or made over time?

The answer may differ depending on the triggering event. For example, in the event of the death of a shareholder, a buyout may be funded through life insurance proceeds, resulting in a more immediate payment. In contrast, if the buyout is to be funded with proceeds from the ongoing operations of the business, the payment may be made over a number of years with interest accruing on the unpaid amount.

These mechanics directly affect economic outcomes. A higher valuation with unfavourable payment terms can ultimately be less attractive than a lower valuation with immediate liquidity.

Where CHS fits in

Cohen Hamilton Steger & Co. is regularly retained to provide independent expert business valuation analyses in connection with shareholder and partnership disputes, buyouts, mergers and acquisitions, corporate reorganizations, and other matters involving private and public companies. Whether a valuation process has been clearly set out in a shareholders' agreement or remains a source of uncertainty, our collective experience across a range of industries, business sizes, and circumstances allows us to provide practical and well supported opinions in both routine and contentious matters.

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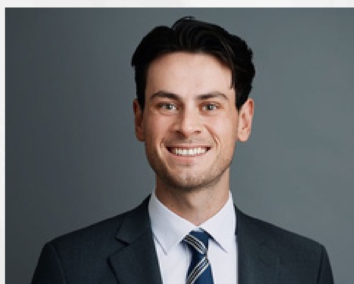

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