

The 50-50 Dilemma

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One of the toughest assignments appraisers confront arises when a business has two equal (50-50) owners and they disagree so much that their corporate marriage must end.

For purposes of this article, assume that:

1. The owners have no agreement differentiating between their roles and authority or which establishes beyond dispute the buyout price for the departing owner. Up to this time, there has been no formal governance structure.
2. One will leave and be bought out; the other will remain as sole owner.
3. The business is not in terminal distress, and at least one owner could continue, with appropriate help, to run it as a going concern.

Appraisers usually enter the dispute when tempers have begun to flare and attorneys have become involved. Our initial charge will be to “value the business for a buyout.” Everyone thinks we will come up with “the number.” The point of this article is that we cannot! So how can we be most effective in helping resolve the dispute?

1. The first thing we have to do is establish our role: appraiser or consultant. As an appraiser, we must be independent and objective. The best way to insure this is to have the company engage us, not one of the parties. Each owner will thus pay half the cost of our services. If we are retained by one side (there is nothing wrong with this), we will be perceived as acting as consultants favoring our client. That situation is not addressed here: the issue is how to proceed when we are acting as appraisers.

2. The second thing we must try to define is the parameters of our engagement: the standard, premise, and level of value. The thesis of this article is that, despite protestations to the contrary which will be voiced by the parties and their advocates, what will truly drive the buyout is investment value, not fair market or fair value. There will be a great deal of posturing, misinformation, and denial about this, but that is the most likely basis on which the parties will ultimately negotiate. The reasons for this will be elaborated below. The premise of value issue arises in jurisdictions (such as the State of California) in which 50% owners can force liquidation. (Remember, we are assuming that, except for this possibility, the business is a going concern. If not, then the parties should quickly realize that the best course of action for both would be to liquidate.) The level of value – whether and to what extent a 50% interest should be discounted for lack of control and lack of marketability – will also be explored below.

When we are introduced, the parties will probably not be able to agree on any of the parameters. They may be emotional and not open to calm reason. Second, they may not grasp the significant potential differences between investment, fair market, and fair value. Third, they quite naturally will maneuver in order to improve their negotiating position, including threatening lawsuits. Because of this, the resolution process will not be as clean or linear as outlined here; there may be regression and loss of momentum as negotiations proceed, or even fail altogether. Dispute resolution is highly risky.

So how can we be most helpful given these complexities? As appraisers, we should position ourselves as “Rational (Wo)Men” and focus on helping each party realize their most favorable economic outcome. To do this, we have to be rigorously honest about what we can quantify and how reliably we can do so, and understand what we cannot do.

We can take the approach of helping the parties establish a reasonable range of values for the interest to be bought out. We should only opine as to ranges we can reasonably substantiate, and avoid getting into difficult and controversial areas (which will be discussed below). What we cannot do is to come up with “the number” – a point estimate of value – and expect the parties blindly to accept it (unless they have hired us to do just that; i.e. to arbitrate.) We must avoid this at all costs, because once we let ourselves get pinned down to a number, we risk alienating both sides and losing our effectiveness.

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Here are three areas to explore which can have the benefit of beginning to get the parties to find areas of agreement. Broach these at an introductory meeting of the parties (assuming they can sit in the same room).

One way to start is to attempt to get them to agree as to what is and is not on the table. To the extent that there are existing contractual agreements that are causing controversy, perhaps they can agree to ignore or abide by them. The parties might have historically agreed to take equal salaries, intentionally maximized to minimize taxes. This blurs the distinction between their return on labor (as managers of the business) and their return on capital (as equity owners). We might suggest that, for negotiating purposes, we research and establish fair market value compensation rates for each manager, and use them in our analysis so that we can get a better estimate of cash flow to equity. We will also need this to determine the replacement cost, if any, of the departing manager-owner.

A second issue to explore is whether the liquidation value of the business is less than its going concern value. If so, then it is in no one's rational economic interest to liquidate, since both could do better by working out a buyout that keeps the business going.

A third issue to explore is whether it is clear that one owner will be the buyer, and one the seller. In many cases, this is already established or obvious (e.g., one party has financial resources and the other does not.) It may be the only thing they can initially agree on!

Finally, we can propose a way to work toward a solution. Going back to the thesis, an analysis of fair market value or fair value is probably not going to be of great value to the disputants. It is IRRELEVANT at what price a third party would buy or sell the business (or a half-interest in it): all the two owners care about is getting their money or getting their partner out. A third party is not part of this transaction. If a buyout is done, it will leave one owner in sole control. All of this leads to the inescapable conclusion that investment value will be the governing standard. Investment value also invites consideration of case- and owner-specific facts such as how wealthy each owner is, what skills they contribute to the business, what the impact of their departure would be, and so forth. Appraisers cannot normally identify or quantify the impact of all such factors, which is another reason in support of providing a value range, not a point estimate.

We could propose to work with each owner to project business performance under each of their sole ownerships (assuming that they have not agreed on who will be leaving) or to do the same thing with each of them with the agreed owner staying and fair market value compensation in place. Each

could provide his or her projection (with our assistance) and its basis. This will identify what might happen to the business should a given owner depart, in terms of changes in revenue, expense, and the risk profile of the business, all of which have obvious valuation implications. We will have to take care to substantiate the equity discount rate, which may be owner-unique.

We could then compare values under each scenario. This might suggest (assuming the parties agree on the valuation analysis; this process might be iterative) who should leave and who should stay, as well as a reasonable value range.

In my experience, this is as far as we can usually go in the resolution process with confidence in the results: developing alternate value indications (a range of values) under the different ownership, return and risk scenarios. This is because the next issue – the applicability and magnitudes of discounts for lack of control and marketability – is so explosive that it can destroy the possibility of a deal.

As appraisers, we know that in 50-50 ownership situations, a 50% interest is clearly not controlling (in the absence of special agreements, as assumed herein). It is controversial whether it is a minority interest, depending on the legal context and in appraisal theory. If it is not a minority interest, then obviously there is no discount for lack of control. However, if it is a minority interest, we have no good data with which to quantify the discount. All of our empirical studies are based on clear (less than 50%) minority interests. Therefore, we are in an empirical and theoretical never-never land which we must avoid if we are to remain credible.

I think everyone would agree that a 50% interest bears a discount for lack of marketability, but again, for lack of empirical data, we cannot reliably quantify it.

Finally, the imposition of either discount will probably be unpalatable to the selling shareholder if presented as such. They will not accept that fact that their interest suffers from lack of control: after all, decisions were made jointly. They may agree in concept that there is a marketability issue, but will still blanch at one of any magnitude. And any data that we present in support of either discount will not necessarily be persuasive.

So, my suggestion is to ... finesse these discounts! Focus on the differential cash flows and values, each of which has a relatively strong basis (each owner's projection, and our determination of the discount rate). This

is a purely pragmatic choice, and a big reason why I believe that investment value is the best standard in these situations.

To recapitulate, we will present a range of values developed using each individual's projection of likely results, with appropriate adjustments for compensation and such, as well as reasonable revenue and expense assumptions. We will discount them at an appropriate rate (which may be different for each owner). The value of the 50% interest will be half of indicated values.

Now, we present this range and its bases to the parties, and revise it based on discussions with them. At some point, we will have taken the process as far as we can given our ability and data, and must let the parties decide where to go from there. They, not we, will negotiate based on other investment value considerations (such as their relative wealth) that we cannot reliably quantify. They can also, with appropriate assistance, get into issues of structuring (e.g. covenants not to compete) to mitigate risk and tax consequences. We may be able to be of assistance in terms of projecting the financial feasibility of a proposed settlement (can the business cash flow support the indicated buyout?) but we must not opine on issues in which we are not qualified.

In summary:

1. 50-50 ownership dissolutions are very complicated.
2. Despite our best efforts, we may not be able to help them reach agreement.
3. We can help resolve them as appraisers, but cannot come up with a final value.
4. We can help the parties reach a series of incremental agreements.
5. The best we can do is to develop a reasoned, reasonable value range.
6. The range reflects the investment values of the enterprise (times 50%) and ignores discounts for lack of control and marketability which are controversial, explosive and difficult to quantify reliably.
7. The resolution process requires that we exercise a great deal of tact, diplomacy, and discretion.