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Strategies to cash out stock in a private company

Commentary by Peter Gampel

Stock ownership in a private company is often a risky venture—risky from the perspective of being unable to readily cash out of one's investment.

Without a properly drafted shareholders' agreement that spells out the buyout mechanism or exit provision, shareholders who do not control the business are often trapped as they cannot easily liquefy their investment. Even with a shareholders' agreement, an immediate buyout may not be possible as other unanticipated corporate problems can surface.

Gampel

Take for example an investor who acquired a 50 percent passive shareholder interest in an operating company that is managed by the top executive, the other 50 percent shareholder.

What if the passive shareholder became aware that excess compensation was being paid to the active shareholder, the consequence of which limits the amount of potential dividends or distributions available for payout to all shareholders? Or what if the passive shareholder alleged mismanagement on the part of the other owner-operator? What can the passive shareholder do to curtail this activity and to exit the company while receiving payment by way of a repurchase of their shares?

The governing Florida statute does not contain provisions for oppression. However, there are provisions in the statute that are grounds for judicial dissolution under Section 607.1430 in the event of fraud, illegality, breach of fiduciary duty or corporate waste that permit a shareholder certain remedies.

The court may order that the complaining shareholder's shares are purchased. Either the corporation or remaining shareholders may elect to purchase at the fair value of the shares.

The determination of fair value involves the application of customary and current valuation concepts and techniques to determine fair value.

However, fair value, unlike fair market value, denotes a different meaning when statutorily applied. For example, in appraisal rights situations, where the company is the initiator of an action to buy back the shares of minority shareholders, in a merger or squeeze-out for example, no valuation discounts would apply where a corporation has 10 or fewer shareholders.

When determining the value of an interest under fair market value, valuation discounts for lack of control and lack of marketability are assumed to be inherent in the analysis. This has the effect of lowering the value of the shareholding to something less than the pro rata value for those shares. The size of these two discounts is dependent on a host of factors.

DISCOUNTS APPLY

The statute for determining fair value for a buyback as a consequence of dissolution proceedings is less clear. There are no provisions that specifically dictate that valuation discounts are disallowed. Typically, the discount for lack of control is not taken into account. However, the discount for lack of marketability may be.

In the previous example, the passive investor-shareholder would be bought out at fair value. It is up to the court to determine the applicability for a discount for lack of marketability to be applied to the pro rata value of the passive investor-shareholder's interest. It may be such that only in circumstances where the company has been negatively affected by the actions of the remaining or purchasing shareholder would no discount for lack of marketability be warranted. The question also arises about the treatment of corporate waste pursuant to a fair value determination. In valuation theory, a business valuation is traditionally forward-looking and would not include the corporate waste or negative financial effects resulting from prior business activities from the active shareholder/business owner.

However, that would be in the context of fair market value when valuing a business or business interest and not necessarily applicable in the context of fair value, which is essentially a forced sale.

When preparing a business valuation or business interest valuation for fair value purposes, there are many additional issues or considerations that must be considered and addressed that will have a substantial impact on the overall analysis and conclusions.