Attorney CLE Series

Corporate Divorce – Shareholder Disputes

October 1, 2015

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Certified Public Accountants and Consultants

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Robert J. Grossman, CPA/ABV, ASA, CVA, CBA

Bob heads our firm's Tax and Business Valuation Groups. He has over 35 years of experience in tax and valuation matters that affect businesses, both public and private, as well as the stakeholders and owners of these businesses. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth. As his career has progressed, Bob has risen to a level of national prominence in the business valuation arena.

His expertise in business valuation is well known, and Bob is a frequent speaker, regionally and nationally, on tax and valuation matters. Bob is a course developer and national instructor for both the American Institute of Certified Public Accountants (AICPA) and the National Association of Certified Valuators and Analysts (NACVA). He has served as an adjunct professor for Duquesne University and Saint Vincent College. He has also written articles for several area business publications and professional trade journals.

After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is accredited in Business Valuation by the AICPA. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

A member of the American and Pennsylvania Institutes of Certified Public Accountants (PICPA), Bob has previously chaired the PICPA Pittsburgh Committee on Taxation. He has also served as Chair of the Executive Advisory Board of NACVA, its highest Board; as well as Chair of NACVA's Professional Standards Committee and its Education Board.

Bob received NACVA's "Thomas R. Porter Lifetime Achievement Award" for 2013. The award is presented annually to one of the organization's 6,500 members, who has demonstrated exemplary character, leadership and professional achievements to NACVA and the business valuation profession, over an extended period.

Bob is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the American Society of Appraisers. He has held numerous offices in various not-for-profit organizations. Bob received the PICPA Distinguished Public Service Award and a Distinguished Alumnus Award from Saint Vincent College.

Bob and his wife, Susie, live in Westmoreland County. They have two grown children.

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Melissa A. Bizyak, CPA/ABV/CFF, CVA

Melissa, a partner in the firm's Business Valuation & Litigation Support Services Group, has practiced in public accounting for over 20 years. She has significant experience in business valuation and tax-related issues for privately-held concerns and their owners.

Her business valuation experience is very diverse, including valuations of companies in the manufacturing, oil and gas and technology industries. These valuations have been performed for various purposes such as financial reporting, equitable distributions, buy/sell transactions, dissenting shareholder disputes, Employee Stock Ownership Plans (ESOPs), value enhancement and gift and estate tax purposes. Melissa also provides litigation support services including expert witness testimony.

After graduating from the University of Pittsburgh in 1994 with a B.S. in Business/Accounting, Melissa spent two years with a local accounting firm in Pittsburgh. She joined Grossman Yanak & Ford LLP in 1997.

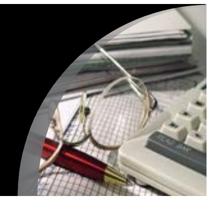
Melissa is a certified public accountant. She is accredited in business valuation and certified in financial forensics by the American Institute of Certified Public Accountants (AICPA). She has also earned the AICPA Certificate of Achievement in business valuation. Additionally, Melissa carries the credentials of Certified Valuation Analyst.

Her professional affiliations include the AICPA, the Pennsylvania Institute of Certified Public Accountants (PICPA) and the Estate Planning Council of Pittsburgh. She is a member and serves as the Chair of the Executive Advisory Board of the National Association of Certified Valuators and Analysts (NACVA).

Melissa has written business valuation course-related materials and serves as a national instructor for NACVA. She has also authored articles appearing in professional publications.

Melissa is a graduate of Leadership Pittsburgh, Inc.'s Leadership Development Initiative. She serves on the Board of Directors of the Children's Museum of Pittsburgh and is a member of the Executive Leadership Team for the American Heart Association's "Go Red for Women" initiative. Melissa is also a mentor for women business owners through Chatham University's MyBoard program.

Melissa resides in the South Hills of Pittsburgh with her husband and their two sons.



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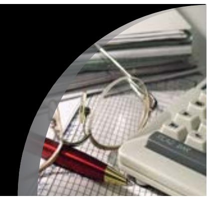

Corporate Divorce – Shareholder Disputes

Introduction

Corporate Divorce

The mere mention of corporate divorce to any business owner immediately invokes a myriad of thoughts covering a vast array of emotions, extending from dismay and dissatisfaction to anger and resentment. Often, this turbulence can lead to fighting, vindictiveness and, ultimately, litigation. Along this paradigm, the parties to the "divorce" can suffer immeasurably, not only from a business and financial perspective, but also on a personal and emotional level. Matters that cannot be easily resolved – due to complexity of the legal and financial issues, personal animosity and disdain among parties or a reluctance to face the inevitable due to changing circumstances – can often extend the corporate divorce process over a number of years.

During the time it takes to reach ultimate resolution, the underlying business in which parties are at odds will suffer as well, thereby affecting them proportionately (and likely, negatively) to their ownership percentages. Focus on the many issues faced by a dysfunctional ownership group in a highly competitive marketplace is almost certain to produce negative outcomes.

The ultimate resolution and settlement of these complex matters has, at its roots, the origin and creation of the affected business at its very beginnings. Often, at the inception of a multi-owner small business, whether it is formed as a corporation or an S corporation, partnership or limited liability company, the owners have some type of historical personal relationship. These instances extend from earlier relationships as coworkers in a prior employment or business environment, to professional colleagues that know each other by reputation, to close social friends, whose relationships span both business and personal interactions. It is not uncommon, of course, that family members often join together to start a new business, which is perhaps the most challenging and dynamic of all business ownership structures.

Because of these relationships, most multi-owner businesses start with an exceptional level of trust and commitment to all other owners. An outgrowth of this degree of trust is generally a lack of focus on critical organizational documents and a certain "looseness" in addressing technical matters, both legal and accounting, in forming the enterprise. The decision to move forward with the creation of a new business is an exciting time for all involved and, oftentimes, these authors have observed that the upbeat nature of this time period in the businesses' lifecycle can lead the owner group to be complacent and completely dismiss the many different complications that could arise at the other end of the businesses' lifecycle.

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However, the inception of a business is the most appropriate time to plan for issues that may arise over time that may require equity owners be redeemed and their ownership interests liquidated. While such outcomes may seem farfetched and unimaginable at the inception of the business, it is always prudent and wise to carefully assess these risks at the outset and to structure guiding legal documents to address these risks to the satisfaction of all owners. The process of corporate divorce is far more challenging, costly, and time-consuming without quality governing documents that dictate the means by which these transactions are to be effected.

A very important element of those provisions within the organization's documents are those pertaining to how the equity interests of that entity are to be valued as well as the many valuation-related issues that might arise, including the standard of value to be used, the date of valuation, and the definition of events that might trigger such a valuation. As will be discussed later in these materials, valuation is often the most perplexing matter to be resolved in a corporate divorce. Though the process is complicated and, at times, may seem overwhelming to the parties, the authors have observed that a lack of guidance in the governing documents can often lead to substantially more difficulty in determining a conclusion of value.

In addition to equity owner redemptions and sales, several other important issues should be addressed at inception. Issues related to employment with the new enterprise, operational assignments related thereto and owner group expectations for each position should be set forth as clearly as possible to ensure that an environment exists to allow for effective governance and as little subjectivity as possible in meeting expectations. Additionally, cash compensation determinations (and the manner in which they will be set), bonuses, vacation allowances, medical leave and illness provisions, and fringe benefits such as medical health insurance, automobiles, cell phones, etc. should all be addressed, if possible. Note that it is not necessary that these items be exact at inception; rather, the conceptual framework should be put in place to mitigate as many future challenges as possible. It is also important to understand that the provisions set forth in these initial agreements are subject to change and usually can be changed by a majority vote of the equity owner group (though a provision for unanimous vote may be invoked by virtue of including such a provision). Prudent governance of any business entity should include a periodic review of the organizing documents to ensure compliance and allow assessment of whether they are actively meeting the goals and objectives of the organization.

Especially important in consideration of these documents are those provisions that dictate termination scenarios, as well as related issues such as, employee/equity owner recourse, severance or separation payments (amount and term/timing of payments), covenants-not-to-compete and fringe benefit matters, future protections of business knowledge and business confidentiality (all in addition to the equity owner interest transfer). Other critical items to be considered at inception of the business might include restrictions on transferability

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of equity owner interests and rights of first refusal, for example. Greater detail on these items will be provided later in these materials.

As participants will observe throughout today's presentation, corporate split ups and divorces are not significantly different than what might observed in family court in a marital dissolution proceeding. Emotions can run extremely high and, oftentimes, the authors have observed equity owners feeling betrayed by their business partners and co-owners. Depending on the circumstances and the length of time associated with the business during which equity owner dismay and dissatisfaction has evolved, these feelings can run very deep. Unfortunately, as many multi-owner businesses are started with family members, certain parties to these matters may find themselves seeking an invitation to Thanksgiving dinner elsewhere than where they have traditionally attended. An unfortunate side effect of these types of issues is the loss of certain relationships that took years to nurture and build.

The program that we have developed for today's session is intended to introduce a number of important considerations required of lawyers leading a client through the process of a corporate divorce. The program is not intended to set forth every detailed legal consideration but, rather, to identify key areas of concern and import, focusing as much on the financial aspects of the process as the general legal matters. In attempting to present this information, we have segregated the materials into the following chapters:

- ***Introduction***
- ***Chapter I*** – Causes of Corporate Divorce
- ***Chapter II*** – Corporate Divorce Resolution Alternatives
- ***Chapter III*** – Documents in Equity Owner Dispute Resolution
- ***Chapter IV*** – Role of Independent Financial Specialists
- ***Chapter V*** – Valuation Issues
- ***Chapter VI*** – Forensic Issues
- ***Chapter VII*** – Case Law Update
- ***Conclusion and Practical Considerations***

The authors, as well as the Partners and professionals of Grossman Yanak & Ford LLP, thank you for your attendance this morning and for taking time from your busy schedules to join us. We appreciate the support you have shown our Firm in the past and we look forward to working with each of you in the future.

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I. Causes of Corporate Divorce

The course over which a business lifecycle runs carries with it many ups and downs. Those most successful in navigating these challenging waters are most often those who are able to stay focused on the bigger picture and the rewards (financial and otherwise) that accrue to the founders if the business is able to attain, and maintain, some level of success. Unfortunately, the human side of nature too often takes over, and founders and other equity holders often find themselves losing this very focus. Instead, attention turns to personal gain and personal satisfaction, rather than acting to the betterment of the collective ownership group. When this situation occurs, it is generally only a question of time before other affected parties within the ownership group begin to manifest feelings of dismay, dissatisfaction and unhappiness. Allowed to fester, without attention and an attempt at reconciliation, this discord will most certainly lead to equity owner conflicts and possible exit.

In many cases, exiting equity owners feel as if they were mistreated. In the experience of the authors, there seems to be just as many situations where there have been some improprieties on the part of the remaining equity owners as those in which departing owners have been treated fairly. This appears to be true, though many more documented cases address the issues of equity owner oppression and abuse.

In particular, the business entity structures allowing a single equity owner, or a limited group of equity owners, the ability to control major management decisions within the business often leads to charges of an overall "unfairness" leveled by the non-controlling equity owner(s). Certainly, in these circumstances, it is much easier for such unfairness to occur. As a result, every state maintains certain protective statutes designed to assist the non-controlling equity owners with protection of their investment interest in privately-held companies.

Shareholder/equity owner oppression can take place through a variety of actions by those in control. Actions found to constitute such include, but are not limited to: generally oppressive and abusive conduct; withholding of dividends; restriction or preclusion of employment in the company; payment of excessive salaries to majority equity owners; the withholding of information on the operations of the business; misappropriation of corporate assets; denial of appraisal rights to dissenting shareholders/equity owners; failure to hold shareholder equity owner meetings; and, exclusion of minority owners from having a meaningful role in corporate decision-making.[1]

The authors have observed many causes for corporate shareholder/equity owner disputes. Some of the more common, and notable, are set forth below. The list is not intended to be exhaustive, but a representative example.

[1] *Bair v. Purcell*, 500 F. Supp. 2d 468, 484 (M.C. Pa 2007), quoting and citing *Orchard*, 590 F. Supp. at 1557

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Personal Use of the Assets and Income of the Business by an Equity Owner

One of the more common areas of dispute occurs when an equity owner is alleged (or is proven) to have pilfered corporate monies for his/her own enrichment. This is a very common occurrence and an issue which seems to be raised as part of every case of corporate divorce. Oftentimes, the occurrence of such improprieties starts with a small infraction and a lack of quality internal controls. Rarely does it seem that the original intent of the bad actor is to "steal" business assets, but insufficient controls might allow for the expensing and reimbursement of personal expenses such as a family dinner or refueling personal vehicles. While each expenditure and inappropriate reimbursement may seem minor and immaterial, the ability to conduct oneself in this manner generally leads to an extension of such activities until the monies become more significant and important to the fiscal well-being of the business.

It is important to understand that while the amount of the alleged misappropriation might be significant in future negotiations and resolution proceedings, the actual dollar value may not be at the center of the damaged equity owner(s') relationship with the business partner committing the malfeasance. Simply knowing that such circumstances exist, and that the bad actor has not conducted him/herself in a manner that is trustworthy, and financially responsible, can quickly lead to ill will and hard feelings. Oftentimes, it is these types of behaviors that mark the beginning of the end for the equity owners' relationships.

Personal Behaviors and Actions of an Equity Owner of a Civil and Criminal Nature

Sadly, in the experience of the authors, observances of majority equity owner misbehavior is not unusual. On the administrative and civil front, such misbehaviors can span income tax improprieties (from failing to report revenue and overstating expenses, to a failure to remit estimated income tax and trust fund taxes collected from employees), to misrepresentation of financial information to auditors, lenders and minority equity owners. Obviously, the determination of "intent," if proven, can push such misconduct from the level of a civil matter to one of a criminal nature.

Another act of impropriety that the authors have observed is the inappropriate personal conduct of an equity owner that resulted in a claim of sexual harassment. Most often, such issues are contested in a civil forum, but depending on the facts and circumstances of the alleged acts, such behaviors can sometimes broaden to a criminal action.

The breadth of equity owner impropriety on the criminal front can span from criminal activities undertaken outside the business that result in major fines and/or imprisonment, to fraudulent misrepresentation within

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the business to lenders, vendors, customers and regulatory bodies. One need only look at the recent sentencing of the primary equity owner in a Georgia peanut business to observe a "worst case" scenario. Here, under the individual's leadership, peanuts tainted with salmonella were shipped to users and sold to end customers, several of whom died. The owner was punished with 25 years of incarceration, and the company filed for bankruptcy.

Another common example might be driving accidents that occur while equity owners are using company vehicles or conducting company business while under the influence of alcohol or drugs. Circumstances such as these often leave the remaining equity owners to "circle the wagons" as a defense. The worst circumstances can often lead those equity owners to the decision to exit the business or force the equity owner committing the infraction to exit. Rarely does implementation of such a strategy occur without the travails of a corporate divorce.

Use of the Business to Advance the Personal Interests of a Single Business Owner

Beyond the obvious implications of diverting corporate and business entity funds for personal financial gain, certain less-obvious behaviors can allow a single equity owner to use the business in a way that benefits him or her personally. One example in this area is excessive contributions of funds and services to an elite secondary school with the underlying motivation being acceptance of that equity owner's children to attend that school.

An even more common example is nepotism, whereby the equity owner at question is found to be employing individuals with some level of personal relationship with that equity owner. Most often, the issue turns to qualification for the position filled by the related party and the businesses' ability to manage the individual in an arm's-length fashion. Failure to hire qualified individuals to fill open positions in favor of possibly-unqualified candidates holding a personal relationship with the hiring equity owner can be held to constitute a breach of that equity owner's fiduciary responsibility to the business. Such hirings can lead to diminished performance by those employees, thereby, exposing the balance of the equity owners to greater investment risk as a result of weaker business performance.

Financial Success of the Business/Financial Distress in the Business

Interestingly, whether fortunes are positive or negative with respect to the ongoing operations of the business, it seems that equity owner dissatisfaction can arise in due course. On the success side, difficulties can arise with respect to managing equity owner decisions regarding how best to channel the fruits of that financial success. For example, there may be disagreement over whether profits should be reinvested in capital equipment or a business acquisition or, alternatively, distribution of the funds to equity owners.

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Given the vast array of business operational decision alternatives, it should not be surprising that a corporate structure with numerous equity owners will very often fail to garner consensus on all decisions. Such is the nature of any partnership. It is, however, in those instances where one equity owner does not get his or her way in the decision that animosity begins to build and feelings begin to harden.

Again, it is imperative for long-term success that all equity owners in any business remain focused on the greater goals and objectives of the business plan and to be pragmatic when their wishes are not necessarily adopted in day-to-day operational decisions.

All equity owners face the same challenges when the business is in financial distress. In these instances, it is, perhaps, even more difficult to accept dismissal of one's recommendations as a business in distress requires change and possible "retooling." Bad feelings may also arise in such instances due to financial pressure and assignment of blame for the company's current condition. Finally, additional risk may be added to the equity owner group as failure to meet lender covenants can result in the need for refinancing, personal guarantees and/or additional capital contributions. On occasion, the authors have observed equity owners who are financially unable, or simply unwilling, to provide additional funds at the call for capital. The outcome of such a situation is generally a reshuffling of ownership interests, providing greater ownership to those contributing additional capital through the dilution of non-contributing equity owners.

Personal Causes of Corporate Divorce

Not all corporate divorces among equity owners are driven by negative underpinnings and perceived malfeasance by one party against the other(s). That does not mean, however, that these instances are always without controversy. Often, equity owners depart a business for life events that go well beyond the walls of the business itself or equity owner relationships. While the breadth of these reasons can be very broad, the common thread from the position of the diluting or exiting equity owner, is a critical need for cash. Thus, any need for cash may serve as a driver to seek exit from a business enterprise.

Examples of life events that might trigger an equity owner dilution or exit (again, not intended to be exhaustive), might include:

- ***Marital Dissolution*** – Satisfaction of equitable distribution proceedings mandating a certain allocation of marital assets may require that the propertied spouse liquidate certain assets to provide sufficient liquidity to meet his/her obligation to the non-propertied spouse. While it is rarely the case that Courts will force a sale of the propertied spouse's equity ownership interests, it is not uncommon for that individual to elect to liquidate at least some portion of certain equity interests to finalize the settlement process. In addition, depending upon the equity owner's personal liquidity position at the date of the marital dissolution proceedings, there could be a need for cash for personal expenses and legal fees that can only be filled by liquidating some portion, or all, of his or her equity ownership interest.

- *College Funding* – This reason does not require significant explanation. The need to create a liquidity position within the equity owner's asset portfolio to fund college education costs for children may require that he or she sell back to the company some portion or all of his or her equity ownership interest.

- *Illness* – Medical costs and attendant care for the equity owner, his/her spouse or children may drive a need to liquidate the shares of ownership in the company. This can prove to be a particularly difficult situation when the equity owner is personally involved in the operations of the business, providing personal services in exchange for compensation from the business.

- *Retirement* – Cessation of active participation in the business as a result of normal employee retirement can often result in an exit of the equity owner from the position of ownership as well. Sometimes such an exit is predicated upon a need for cash, as is set out above, or can be as a result of different life events. At other times, retirement can simply be an impetus to reallocate assets to investments that are deemed to be less risky. Such an asset reallocation would not be an unusual planning strategy for an individual facing retirement needs and future unknowns.

- *Alternate Investment* – Similar to the reallocation discussion under retirement set forth above, alternative investment simply refers to the departing equity owner's desire to redeploy assets to use funds and wealth currently invested in the company for an alternative investment. Of course, such equity movement is generally predicated upon the terms set forth in the business entity's governing documents, which may impose restrictions through non-compete agreements or non-solicitation agreements on the reinvestment of funds.

- *S Corporation Election* – Limitations imposed by the Internal Revenue Code of 1986, as amended, restrict the election to be taxed as an S Corporation (to be treated as a pass through business entity) to corporations having 100 or fewer shareholders. Often, in corporations having more than the required maximum, steps are undertaken to reacquire ownership interests from a sufficient number of shareholders so as to meet the limitation. In these instances (which are generally noncontroversial in nature, excepting the valuation issue), the exit of departing equity owners does not rise to the level of a litigated matter.

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The Shareholder/Equity Owner Freeze Out

"Freeze outs" are not specifically related to a particular alleged malfeasance on the part of equity owners remaining with the business. Transactions of this type can take on many different forms, but all intend to ultimately force certain shareholders and equity owners to sell their ownership interests in the company.

In effect, these well-recognized techniques are often used to unburden the majority ownership group of problematic equity owners/shareholders. So long as the majority ownership group has a sound business reason for the transaction (beyond that of simply benefitting the remaining equity owners), the transaction, if properly planned and documented, should withstand any challenges. The primary area of legal challenge in these types of transactions centers on accusations that the majority shareholders did not meet their fiduciary responsibilities to the minority shareholders who exited the business.

One mechanism to accomplish a freeze out transaction is the issuance of additional equity ownership shares to the majority owners. In most cases, these additional shares are transferred in consideration of personal services rendered to the business. The outcome of such equity ownership interest transfers is to severely dilute the ownership of those owners being pushed out and to devalue their interests. The result is often a sale of that equity owner's shares to preserve as much value as possible.

Another example of a freeze out transaction might be a limitation on cash distributions imposed by the majority equity owners. This is a particularly difficult circumstance in pass-through business entities such as S corporations, partnerships and limited liability companies, where equity owners might receive Schedules K-1 reporting their shares of the business's income that they are required to include on their personal income tax returns. In these cases, a failure to distribute sufficient cash to pay the tax on the corporate income can force these equity owners into selling their shares. The problem is more evident if the majority equity owners are taking excessive compensation to pay for their taxes.

Giving Rise to the Corporate Divorce

In each of the above-noted situations, the most common remedy is a separation of shareholders and equity owners from the business entity. Unfortunately, the key element of the division, just as in a marital dissolution, is the valuation of the subject equity interest under consideration and the terms under which the matter will be successfully resolved.

Given that nerves are often frayed and feelings hurt by the time a decision to sell by the exiting equity owners is made, it is not a surprise that the process is one that generally includes great deal of antagonism

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and ire. Rooted in distrust by this point in time, the process generally requires a team of professionals led by legal counsel and requires a specific, strategic plan of action.

Very often, the most difficult element of the process is to find a value that the two sides can agree upon. This process can be as simple as determining the value in compliance with a "previously-agreed-upon" valuation formula set forth in Shareholder Agreements adopted at the inception of the business, to the use of multiple business valuators on each side conducting an in-depth analysis and then later deferring to a third, independent, valuator to reconcile differences and make the final decision. Even then, many of these cases end up in formal litigation with judges and triers of fact making the final determination.

In addition to valuation matters, past malfeasance may have resulted in damaging the exiting equity owner's investment value. In these types of cases, it may be necessary to restore historical financial information to a more "normalized" presentation through the application of forensic accounting procedures. This normalization will allow for a determination of value predicated upon normal operations and, if necessary, to quantify any damages the exiting equity owner might have incurred as a result of the alleged bad acts by the remaining shareholders.

Keep in mind that a great deal of controversy in corporate divorce centers on capital ownership structures comprised of both majority and minority shareholders, or equity owners. The attribute of control embedded in majority ownership is the very element that allows the power to conduct operations in a manner that may be perceived as oppressive or lacking fairness to the minority shareholders. While the authors have observed equal ownership business entities going through this process – in these cases, one side is found to be the "de facto" controlling party, perhaps because they are managing the enterprise day-to-day – more situations surround majority/minority equity owner relationships.

The essence of all economic and legal remedies in a corporate divorce is fairness. Fairness is, of course, subject to definition and interpretation, but remains the ultimate goal and objective of the process. Generally, fairness is defined as putting the exiting equity owner in an economic position that he or she would have received had the remaining equity owners not acted improperly. Where improprieties are not alleged, fairness is simply the determination of the value of the equity owner's capital interest in conjunction with the guiding law and governing documents.

Concluding Thoughts

As can be seen, the list of abuses that could cause an oppression challenge is extensive and nearly undefinable. The one known fact, however, is that there is no substitution for careful attention to the possibility

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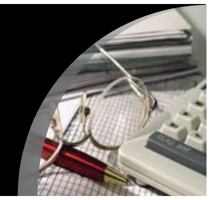
of such matters at inception of the business. In addition, problems arising in the due course of business must be addressed immediately by the entire shareholder/equity owner group. A failure to adhere to these two fundamentals is almost certain to lead to a corporate divorce.

The process of corporate divorce requires all parties to take an internal "gut-check." The process can be exceedingly expensive and take an inordinate amount of time to bring to a successful resolution. To alleviate some of the legal, economic and personal stress associated with the process, the parties can elect to participate in a number of conflict resolution alternatives. These remedies will be discussed in the next chapter of these materials. With an open mind on both sides, it may be possible to shortcut the process.

Given the fluidity and dynamics of equity owner split-ups, the authors have rarely observed success in resolving these matters in short order. That is not to say that such instances do not exist. However, the complexity of the economic determinations and the complexities of the legal process, combined with the dynamics of betrayal and mistrust (real or perceived) tend to exacerbate an already-difficult situation. In such cases, the length of time to accomplish fair and equitable resolution can be significant.



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II. Corporate Divorce Resolution Alternatives

Assuming that the departure of the exiting equity owner is accompanied by controversy, and at least some level of animosity, it generally proves prudent to begin the process of exploring resolution (legal, economic and otherwise), in a less-formal setting. Of course, as is well known within the legal profession, each step upward on the ladder of formality carries with it differing strategic initiatives and opportunities for the clients represented. The following mechanisms may be useful in preventing an all-out and protracted war among the affected parties.

Internal Equity Owner Meetings

The starting point for driving resolution of any conflict is often to simply allow the parties to meet and discuss the problems that they are experiencing. Very often, these face-to-face meetings can be productive as they allow for venting by both sides, and as a result of unloading some of this emotional baggage, there is a better platform from which to start the more-meaningful and important task of addressing the critical issues.

The benefits of such a forum are that all involved parties are in the same room, and the meeting is held between and among the affected equity owners without the more-formal defensive posturing associated with having attorneys and other advisors present. The power of historical relationships can often lead to reasonable discussions and a sense of common interest between the parties. In these instances, the primary motivation and goal is usually to facilitate a general framework for resolution of the dispute. Formalization and finalization of this "tentative" resolution framework should never be undertaken without interaction from legal counsel.

The negative aspect of such a process is in exactly what information might be revealed by either side that could later prove detrimental to that equity owner's position in the future, should the matter not be resolved at this level. In addition, the authors have observed instances where one or more parties have struck an agreement that was nonsensical and, simply, not possible. Thus, it is imperative that proper preparation be undertaken prior to these internal equity owner meetings, including discussions with counsel and advisors so that the equity owner is moving his or her position forward in a realistic and meaningful manner.

Finally, any success that might be garnered from such a process is predicated upon objective and thoughtful discussion. A failure to overcome emotions can prove exceedingly detrimental to the process, not only circumventing success at this level, but also further exacerbating hard feelings as the process moves forward, if the parties should fail to attain resolution at this level.

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Internal Equity Owner Meetings – with Legal Counsel/Advisors

Internal equity owner meetings in the presence of outsiders differ markedly from the discussion above. The dynamics of such a meeting change due to the formality of having advisors, especially legal counsel, present. However, while there may be more of an air of formality to this type of meeting, thus, pulling all parties away from their comfort zones, having advisors in the room can be beneficial and lead to higher-quality results if the meeting is planned carefully.

The first benefit to including outside legal counsel at such meetings is the minimization of emotional exchanges and the immediate "business-like" environment that is created with the presence of outsiders. The choice of the person taking charge of presenting each side's position at the meeting (i.e., whether it is an equity owner or one of the attorneys), will often dictate how much negative banter occurs, thereby allowing more opportunity for issue resolution.

The key element of any meeting is the ability of the equity owners involved in the dispute to be attentive in all communications to ensure that they do not say things that are harmful and harden feelings in an already difficult setting. Furthermore, it is critical that information provided in such a forum does not work to weaken positions that might later be important to a successful resolution. Such considerations demand that careful planning be part of any attempt to settle issues in such a meeting.

An additional, and important, benefit of such a meeting is to allow legal representatives from both sides to hear the discussion firsthand. Emotional circumstances and a lack of legal skills can often lead the equity owners in dispute to misinterpret information that was conveyed throughout the course of the discussions. The presence of legal advisors can go a long way to prevent this problem.

The Mediation Alternative

A mediator is often used as a means to get the parties closer to the path of agreement or to come to an agreement. The issue of trust is not relevant in a mediation hearing as the party conducting the mediation is totally independent of the issues facing the involved equity owners. Furthermore, the mediator will more-easily be able to maintain a course of objectivity because he/she has no direct involvement. There is never anything to gain from a decision in either direction by a mediator.

Trained mediators bring a variety of skill sets to the table. Oftentimes, the most important of these skills is the ability to work through family and personal matters, ego issues and other interference caused by emotional ill will and hurt feelings, and to focus on the task at hand. Mediators possess any number of different technical skill sets so it is imperative to select a mediator with the technical expertise in the disciplines required to drive a resolution of the issues at hand in any specific case. Otherwise, the parties at odds might find themselves in a worse position than had they not undertaken the mediation process.

The Use of a Trusted Advisor

The use of a single attorney, as well as other "non-attorney" advisors, in such conflicts is relatively common. The advisor(s) might be the company's or the equity owner's legal representative, accountant, close friend or mentor, an outside business consultant or just about anyone else the parties find trustworthy and credible.

The key element in using these advisors is, first, qualification. The equity owners must ask themselves if this individual is qualified to address the technical aspects of the issues under contention. If not, is that advisor able (and willing) to assist with the identification of individuals holding the required technical expertise?

Just as pressing, when engaging advisors, is the determination of whether that individual can maintain an attitude of independence and objectivity. The use of an accountant or other advisor who has served the company in the past could be challenged on independence due to the prospect of he or she continuing with the remaining equity owners. For this reason, it would not be unusual for certain of those parties (particularly Certified Public Accountants) to recuse themselves on the basis of conflict of interest.

A failure by the advisor to bring the requisite expertise to the table, as well as challenging conflict of interest issues, could result in splitting the difference and simply balancing arguments on both sides to avoid any implication of favoring one party over the other.

Engagement of Outside Management

Though somewhat extreme (and rarely used), equity owners facing significant issues with respect to the operation of the business might consider bringing in an entire outside management group to function as the company's management for the benefit of all equity owners. In the author's experience, non-equity-owner management is not unusual. However, in circumstances such as corporate divorce, it is exceedingly rare.

There may be merit to the consideration of adding a member or two from the outside to the Board of Directors or current management team. Such an unbiased opinion could serve to eliminate some of the stresses contributing to current circumstances. However, to be really useful, it is first necessary that all equity owners agree to embrace recommendations from this individual in a positive manner and with due consideration.

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Business Reorganization

Should the business be comprised of at least two operational divisions (either by product line and service offering or geographic location), it may be possible to divide the business entity into two or more separate companies. Such a process can serve to satisfy the parties at odds, as each will walk away with equity ownership of his or her company.

Many issues – tax, operational, legal and practical – influence whether an approach that divides the company will work to resolve the issues at hand. Perhaps the most important of these factors is whether the equity owners have the requisite skill sets to manage the separate companies. It is also necessary that the equity owners have a real interest in undertaking such a division of the company. This is especially true if, as a result of the division, one of the parties will be required to uproot his/her family and move to the location of the division that he/she might receive.

The economic and tax complexities of corporate divisions are beyond the scope of today' program. Please feel free to contact the authors should you have an interest in this strategy on behalf of your client.

Sale of the Entire Business

Though a sale of the business may seem even more extreme than some of the earlier resolution alternatives, there are occasions when wounds are so deep and a general level of depression is observed among the ownership group, that everyone simply wishes to call it a day and sell the business. In this way, everyone's interest is served as the resultant consideration in any completed transaction is that which has been negotiated by third parties at arm's-length.

Again, today's program is not intended to address the many facets of selling a business, but suffice to say that, there are primarily sales of assets and sales of stock or equity interests. Within these two broad types of sales there are those that are consummated in taxable transactions and those accomplished on a tax-free basis.

Selling the business as a resolution alternative is extreme and most likely occurs where the equity ownership group is ready to move on anyway. Generally, this decision is not made as a direct result of corporate divorce. However, a great deal of effort and cost could be avoided if a sale of the business was already under consideration.

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Single Equity Owner Buyout

By far, the most common alternative to resolve equity owner disputes and issues is to simply repurchase that equity owner's shares or other ownership interest. This approach is obviously the one that directly addresses the complaints of the equity owner in question. At the end of a dispute settled in this manner, the equity owner surrenders his/her shares, partnership interests or limited liability company member interests.

In exchange for surrendering the ownership interests, the selling equity owner receives valuable consideration (generally cash) and realizes a liquid, economic return on his/her investment. Since he/she is no longer an equity owner, the majority shareholders do not have to interact with him/her after the closing of the transaction.

The issue, of course is in the valuation of the interest, and how best to structure and fund the repurchase. Whether the company repurchases the shares and adds the cost to Treasury shares within their equity section of the financial statements or, other equity owners acquire the selling equity owner's interest, the structure is certain to have an influence of the deal.

While most equity owner interest repurchases arise from control equity owners acquiring the interests of minority noncontrolling equity owners, it is always possible that the larger blocks of minority ownership interests could take out the majority owner. Though not as common, this acquisition of control does happen regularly.

Arbitration As a Resolution Alternative

Arbitration offers yet another resolution alternative to entering the court system. Though a more formal approach, the intent of arbitration is always to push towards a quick resolution of the contested issues and matters without causing the parties to incur significant cost.

Arbitration can be voluntary or mandatory (although mandatory arbitration can only come from a statute or from a contract that is voluntarily entered into, where the parties agree to hold all existing or future disputes to arbitration, without necessarily knowing, specifically, what disputes will ever occur), and can be either binding or non-binding. Non-binding arbitration is similar to mediation, in that a decision cannot be imposed on the parties. However, the principal distinction is that, whereas a mediator will try to help the parties find a middle ground on which to compromise, the (non-binding) arbitrator remains totally removed from the settlement process. He/she will only give a determination of liability and, if appropriate, an indication of the damages payable. By one definition arbitration is binding; as such, non-binding arbitration is, technically, not arbitration.

Arbitration, unlike mediation, generally offers a process similar to a court setting, wherein the parties will have an opportunity to conduct limited discovery and present evidence and testimony before the appointed

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arbitrator. The definitive nature of the arbitrator's decision on matters related to corporate divorce are founded in the governing documents (Shareholder Agreements, Partnership Agreements, LLC Operating Agreements) of the organization. Common clauses within these agreements generally include:

- The location of the arbitration hearing,
- The number of arbitrators that will hear the matter,
- The selection process for the arbitrators,
- Whether the arbitration hearing will be an independent proceeding or an administered proceeding,
- The method by which the arbitration will be conducted (full trial, mini trial); applicable rules of evidence, including the submission of expert witness reports; administrative process of discovery, etc.,
- The length of time to be allotted to the arbitration hearing,
- The specific rules to be followed throughout the course of the arbitration hearing,
- The jurisdiction of the arbitrators,
- Whether the arbitrator's findings will be binding or not, and
- Appellate review remedies (if any).

If applicable to the matter at hand, arbitration allows an opportunity for the parties to attain a resolution based on their best evidence and arguments. Unfortunately, many older governing documents do not contain necessary arbitration clauses, and those that do often do not contain the necessary language to provide sufficient guidance to effectively conduct an arbitration hearing without additional efforts.

Resolution within the Courts

In the author's experience, the Courts do not embrace the idea of addressing disputes among business partners and equity owners. In fact, from discussions with members of the legal profession and judges via treatises and personal interviews, it appears that the Courts' hands are tied in these matters. Often, few tools are available to them by which they can resolve such disputes. In general, unless a failure to adjudicate some resolution to a corporate equity owner dispute will result in irreparable harm to the equity owners or the business itself – damage which cannot be sufficiently addressed with a damages award – the Courts are not open to action. In these circumstances, the Courts are clear that the parties within the corporation, and the governing documents, should guide the resolution process.

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Pennsylvania corporate law (15 Pa. C.S. §1981), sets out the following statute governing such matters:

Upon application by a shareholder or director of a business corporation, the court may entertain proceedings for the involuntary winding up and dissolution of the corporation when any of the following is made to appear.

(1) The acts of the directors, or those in control of the corporation, are illegal, oppressive,or fraudulent and, that it is beneficial to the interest of the shareholders that the corporation be wound up and dissolved.

(2) The corporation' assets are being misapplied or wasted, and that it is beneficial to the interest of the shareholders that the corporation be wound up and dissolved.

(3) The directors are deadlocked in the direction of the management of the business and affairs of the corporation, and the shareholders are unable to break the deadlock, and the irreparable injury to the corporation is being suffered or threatened by reason thereof.

The law (15 Pa. C.S. §1984) further allows, that:

[U]pon the filing of an application under this subchapter, the court may issue injunctions, appoint a receiver ***pendent lite*** *with such powers and duties as the court from time to time may direct and proceed as may be requisite to preserve the corporate assets wherever situated.*

Though these laws are in place, it has not been the experience of the authors that the Courts often undertake such serious actions.

Another avenue of recourse within the Courts in equity owner matters is to appoint a custodian to run the business in place of the current management team. The worst outcome of any dispute between equity owners is the dissolution of profitable company with good financial and economic prospects. In those instances where current equity owners in management simply cannot work together, appointment of a custodian may offer the Court its only option. Though rare, a Court-appointed custodian generally steps directly into the shoes of the current management team and essentially operates the business at his/her discretion at the order of the Court.

Pennsylvania business corporation law provides the governing statute allowing for appointment of a custodian in these circumstances:

§1767. Appointment of custodian of corporation on deadlock or other cause.

(a) General rule. – Except as provided in subsection (b), upon application of any shareholder, the court may appoint one or more persons to be custodians of and for any business corporation when it is made to appear that:

(1) at any meeting for the election of directors, the shareholders are so divided that they have failed to elect successors to directors whose terms have expired or would have expired upon the qualification of their successors;

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(2) *in the case of a closely held corporation, the directors or those in control of the corporation have acted illegally, oppressively or fraudulently toward one or more holders or owners of 5% or more of the outstanding shares of any class of the corporation in their capacities as shareholders, directors, officers or employees; or*

(3) *the conditions specified in section 1981(a)(1), (2) or (3) (relating to proceedings upon application of shareholder or director), other than that it is beneficial to the interests of the shareholders that the corporation be wound up and dissolved, exist with respect to the corporation.*

Subparagraph (c) under this same provision notes:

(c) *Power and title of custodian. – A custodian appointed under this section shall have all the power and title of a receiver appointed under Subchapter G of Chapter 19 (relating to involuntary liquidation and dissolution), but the authority of the custodian shall be to continue the business of the corporation and not to liquidate its affairs and distribute its assets except when the court shall otherwise order.*

While the appointment of an outside custodian may make sense from the perspective of the Court, given the dynamics of the shareholder/equity owner situation, it generally proves to be a poor decision because the outside custodian rarely has the technical and operational acumen of the equity owner groups in these businesses. Again, in the experience of the authors, excepting cases of bankruptcy, Court-appointed custodians do not appear to be a common course of action in the Commonwealth of Pennsylvania.

Most actions within the Courts regarding fairness among partners/owners in a business setting are addressing economic damages, which are often tied to valuation. These issues are, of course, matters of fact, and establishing those facts to the satisfaction of the trier of fact is a more-common element of corporate divorce addressed within the Courts.

Concluding Thoughts

As with any internal dispute, shareholder and other equity owner difficulties are best handled quickly and inside the group of affected owners. Allowing the issues and perceptions to grow without addressing them in a timely manner is a practice that will cause greater pain for everyone, as well as the company, in the future. Certainly, the number of openings for discourse and resolution, prior to entering the court system in a formal manner, offers all parties an opportunity to "clear the air", come to reasonable solutions and, resolve the issues to the benefit of all.

III. Documents in Equity Owner Dispute Resolution

Any shareholder/equity owner dispute resolution begins with gathering all information that governs the legal rights and obligations of that person. The starting point, of course, is legal statute and law. The second part of that analysis is judicial precedent, and the third component is the underlying documents governing operation of the business and granting shareholder/equity owner rights and obligations at inception of the business.

The statutes speak for themselves and are absolutely outside the scope of today's presentation. Applying statutory law to the facts and circumstances of any legal issue is a matter for those trained and experienced in the profession of law and is outside the expertise of today's presenters.

Judicial precedent is addressed later in these materials, but only so far as the case law under observation has a focus on financial matters of the nature generally considered by the authors, and to which they provide specific financial and analytical calculations and procedures. As always, these services are most often rendered on an independent and objective basis, thereby allowing expert witness testimony, if necessary. However, in these instances, the procedures are guided by legal counsel who steps into the shoes of the client to ensure that client/attorney privilege is maintained throughout the engagement.

The third element, original and amended governing documents (for the most part, executed at inception of the business), may be the most critical source of information. While statutory law may provide certain protections by allowing the parties initial or default rights and obligations, the business laws of most states grant shareholders/equity owners great flexibility and latitude in fashioning the business and the owners' rights and obligations as they, as an ownership group, deem most appropriate.

Keep in mind that many documents, organizational and operational, could affect some aspect of a client's case in a corporate divorce action. In evaluating the breadth of documents that should be reviewed, it is always better to go with a broader document request than one that is limited to what might generally be referred to as "corporate" or "organizational" documents. Early engagement of financial experts, business valuators and/or forensic accountants (whose services are detailed in later sections of these materials), can assist legal counsel with interpreting which of the "non-organizational" documents might be helpful in the early analysis process.

The initial selection of documents is even more critical if legal counsel is representing the "outside" shareholder/equity owner who does not have day-to-day involvement, and document access can only be garnered through production of document orders.

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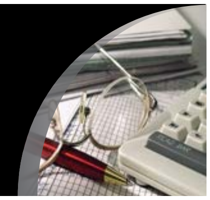
Some of the more common documents that the authors look to in meeting professional standards with respect to conducting a business valuation or in the application of certain forensic procedures include the following:

Organizational Documents

- Articles of Incorporation and Corporate Bylaws
- Limited Liability Company Operating Agreement
- Limited Liability Partnership Operating Agreement
- General Partnership Agreement
- Limited Partnership Agreement
- Board Minutes and Resolutions, generally for the previous five years
- Shareholder Agreements
- Buy-Sell Agreements
- Voting Trust Agreements
- Pledge Agreements
- Capital Stock Share Certificates
- Capital Stock Books of Record, recording historical issuance and retirement of shares
- Employment Agreements
- Stock Option Agreements
- Warrant Agreements
- Rights of First Refusal
- Stock Transfer Restriction Agreements
- Non-Compete Agreements
- Non-Solicitation Agreements

Operational Documents

- Divorce Agreements
- Property Settlement Agreements
- Equitable Distribution Agreements
- Prior Equity Interest Repurchase Agreements
- Franchise Agreements
- Joint Venture Agreements
- Loan and Financing Agreements
- Letter Agreements
- Personal Guarantee Agreements
- Subordination Agreements
- Security Agreements
- Mortgages
- Patent Agreements
- Licensing Agreements
- Trademark and Copyright Agreements
- Collateralization Agreements



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There is no question that the number and types of documents will vary from one engagement to another. Likewise, the importance of any particular document will change from case-to-case, depending upon facts and circumstances and governing state law. However, as can be seen from the listing (which of course, is not exhaustive), the possible number of documents is daunting, and the complexity contained within each document calls for careful scrutiny and analysis by legal counsel in setting strategy for attempting resolution of the matter.

The critical nature of these documents is simply identification of equity owner rights and obligations. By virtue of the terms and content of each, there may be adequate guidance therein to accomplish resolution of many, if not all issues of concern in a corporate divorce. Such documents might provide the process by which disputes among shareholders can be resolved. Furthermore, many businesses possess organizational documents that provide for the means and methods by which valuation of any particular block of equity ownership might be valued. Additionally, the terms and conditions for accomplishing the repurchase of equity shares is often present, so the methods by which the selling shareholder will be paid for his or her shares is clear and straightforward.

Unfortunately, much of what is found in dated documents reflects less-than-useful information. A lack of clarity in definitions, as those definitions have advanced and gone through a refinement process, generally makes interpretation difficult and opens the door to varying interpretations among the equity owner group. Such openings often pave the way for conflict and interferes with issues resolution.

Buy-Sell Agreements

An example of the types of issues that can be troublesome in outdated and/or poorly crafted documents can easily be observed in the buy-sell agreement. While such organizational documents are common, many of the specific provisions within the buy-sell document can lack the requisite clarity and definition to be useful to avoid conflict at relevant action dates. That being said, a well-crafted buy-sell agreement is a must for all businesses, and should address equity transfer issues in a manner that is understood by all parties at inception of the business and thereafter.

Benefits of Buy-Sell Agreements

There are many motivations to adopt a buy-sell agreement, including the following:

- It allows for an orderly transition of ownership at certain terms, if specifically-identified events (triggering events) occur, by setting the purchase price or formula for determining the price.
- It provides a guaranteed market for an ownership interest upon occurrence of a triggering event.

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- Clarity in the agreement minimizes the potential need for adversarial legal intervention.
- Funding mechanisms may minimize the business' or purchasing owner's stress relating to payment for the selling owner's interest.
- Having the agreement in place provides income protection and financial security.
- It provides protection from sharing control of the business with an inexperienced or untrustworthy outsider.
- It can provide certainty and continuity.

Detriments to Buy-Sell Agreements

The lack of clarity relating to any number of provisions in a buy-sell agreement can lead to owner disappointment, controversy, and even litigation. It may be discovered upon a triggering event that there is a conflict between the language in the agreement and the intentions of the parties. It is critical for all parties to the agreement to understand how the agreement will operate at the appropriate dates in order to determine prices and terms for future transactions.

The funding device is critical to the parties' ability to transact the repurchase envisioned in the agreement. Oftentimes, too little focus is provided to this aspect of the buy-sell agreement. There are three common funding mechanisms including insurance, sinking funds and pre-agreed payment terms. What happens all too often is that the amounts of the funding mechanisms are not adjusted as value changes, leading to issues upon a triggering event.

Valuation Elements of Buy-Sell Agreements

As we will address later in this presentation, a routine valuation matter could turn into a very high-anxiety and intense experience for all parties involved. One of the most crucial questions to ask all parties to the agreement is the following: if a triggering event occurs, will the valuation mechanism in the buy-sell agreement accomplish the objective of providing a price for the company's stock at the level the partners/shareholders agree to be reasonable?

When a business valuator is engaged to determine the price of the selling owner's shares, certain areas must be addressed in the buy-sell agreement to provide proper framework and guidance to the valuator. The more an agreement elaborates on these key areas, the less likely it is that uncertainty and controversy will result. It is always a best practice to have the valuation-related language in a buy-sell agreement reviewed by a qualified business appraiser.

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Problem Areas in Buy-Sell Agreements

Buy-sell agreements are complex, and many factors need to be addressed in an agreement to avoid future struggles in interpreting the document. It is important to consider the purpose of the buy-sell agreement as well as address triggering events and valuation method possibilities. A detailed and clearly-written buy-sell agreement will largely benefit business owners.

Problem areas in the Agreement relating to valuation matters may include: how the value is to be determined; the valuator selection process; valuator qualifications; procedures that might arise in the event that the initial valuation is deemed unacceptable by one of the parties; the party(ies) responsible for payment for the valuation; the standard (or definition) of value to be used; the valuation date; whether discounts are to be applied; and how the repurchase is to be funded. Each of these items will be discussed later in these materials, but suffice to day, that a lack of absolute clarity in any area is likely to result in an equity dispute at some point in the future.

Other Documents

A buy-sell agreement, and issues contained therein, is just one example of the difficulties that might be encountered in conjunction with preliminary document review in a shareholder/equity owner dispute. Other examples that will have some effect on the issue resolution would include:

- Agreements including certain Rights of First Refusal,
- Documents with restrictive equity interest transfer provisions,
- Documents detailing equity interest repurchase funding mechanisms, including subordination provisions,
- Lending documents with personal guarantees, and
- Employment agreements, including performance bonus calculation methodologies.

Concluding Thoughts

In conclusion, document content within any business carries a great deal of import in conjunction with corporate divorce. A complete understanding that these documents will form the backbone of any strategies later developed to attain a fair resolution is paramount to firmly grasping the matters under dispute. Moreover, for clients starting new businesses (or those that are not yet in an equity owner dispute), document review is an excellent way for advisors to endear themselves to business owners, should they identify provisions requiring modification to alleviate potential future pain.

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IV. Role of Independent Financial Specialists

As noted earlier in these materials, there are various types of shareholder disputes that fall in the category of a corporate divorce. Typically, the type of work described in this chapter is performed in situations where there is an imbalance of power between controlling shareholders/equity owners and minority owners or a deadlock among equal owners.

The type of dispute influences the assignment(s) that are requested of the financial specialist. Often, financial specialists are sought to provide business consulting, accounting, audit, tax and valuation services. Therefore, the financial specialist needs to have a clear understanding of the type of dispute, including whether or not it is a circumstance of pending or threatened litigation, in order to assist the client and/or legal counsel with the determination of what services may need to be performed. The financial professional will work closely with legal counsel to provide assistance regarding the services that might be employed in a particular project based on specific facts and circumstances.

In situations of pending or threatened litigation, the financial specialist can be engaged as either a consulting or testifying expert. This distinction is very important and will have an influence on the manner in which the expert conducts the work.

Independent financial specialists can provide business valuation services, forensic accounting services, litigation support services or a combination of all of these. A brief description of each of these services follows.

Business Valuation

Shareholder disputes typically involve a disagreement over the value of an owner's equity interest. As such, a business valuation expert can fill a critical role in resolving shareholder disputes. The valuation expert is typically engaged to provide an independent opinion of value of the equity ownership interest at issue.

The valuation expert should develop a clear understanding of how the type of shareholder dispute impacts the purpose and objective of the assignment, the types of valuation adjustments that can be made, the approaches and methods that should be applied, and the form and content of the valuation report. This understanding will allow the valuation expert to discern whether the valuation assignment includes the valuation of the entire company as is or the value of the company to the control owner.

The valuation expert will seek information relative to the existence of a buy-sell agreement or other shareholder agreements, as well as any other unusual shareholder rights or obligations or other contractual terms

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or conditions. As discussed in the previous chapter, these agreements may provide an indication of how the interest should be valued or contain provisions that have an impact on value.

In the event that the valuation is prepared in connection with litigation, the valuation expert will look to legal counsel for guidance regarding relevant judicial precedent.

The same business valuation process, approaches and methodologies will be applied in a shareholder dispute as they are applied in connection with other types of valuation engagements. However, attorneys and their clients should be mindful of several aspects of business valuation that are unique to shareholder disputes. Chapter V of these materials addresses issues faced by the business valuator in connection with those assignments prepared for shareholder disputes, as well as considerations that are specific to this area.

If the shareholders/equity owners involved can come to an agreement as to the value of the subject equity ownership interest, then all parties could avoid costly litigation in which the courts may, ultimately, decide on the value. Once at trial, judges and triers of fact are given wide latitude in determining what is "fair" in shareholder divorce cases.

Forensic Services

In matters that extend beyond value concerning alleged suspicious acts on the part of one or more equity owners of a closely-held company, and which may include pending or threatened litigation, there may be instances where financial professionals are requested to take an in-depth review of the financial records, internal control systems, and operating policies of the subject company. The role of the financial professional, in this instance, turns to more of a forensic nature and will go well beyond the elements and construction of the financials of a closely-held company. The type of forensic services performed by financial experts in these cases can include:

- Investigation, identification and quantification of:
  - Misappropriation or theft of physical assets that were acquired and held by the company
  - Fraudulent and illegal financial transactions
  - Income or opportunities diverted from the company
  - Funding of personal expenditures through corporate accounts
  - Excessive compensation and benefits paid to active and/or majority shareholders
  - Corporate profits available for distribution
- Breach of fiduciary duty on the part of the majority shareholder(s)

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- Wrongful termination of minority shareholders
- Exclusion from involvement in major business decisions
- Involuntary dissolution of a business
- Review of operating policies, procedures, and internal control deficiencies

In performing any of the projects listed above, the financial expert should gain an understanding of the subject company's policies, procedures and internal controls. This knowledge will assist the expert in assessing the quality of available financial information. The financial expert should gain an adequate understanding of the shareholders'/equity owners' past and current positions within the company.

The financial specialist may be requested to estimate both the historical and future unjust enrichment to the majority shareholder(s) (or defendant(s)). Additionally, based upon a number of the services above, the financial specialist may be requested to estimate any historical and expected lost profits to the minority shareholder (or plaintiff). The approaches and roles of forensic experts are discussed in greater detail in Chapter VI.

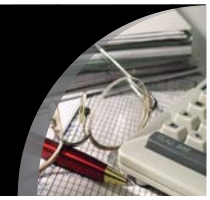
Other Consulting Services

In addition to providing business valuation and forensic accounting services, there are other consulting services that a financial professional can provide. These services can include consulting on shareholder and employment agreements and assisting in settlement negotiations between the shareholders/equity owners. If the matter leads to litigation, financial professionals can provide general litigation support, including assistance with discovery, strategy development and deposition preparation, as well as direct and cross-examination consultation.

Litigation and dispute resolution can be an expensive and time-consuming process, which ultimately takes a toll on a company and its operations. There will be lost working hours of key personnel in connection with gathering information for the expert as well as time spent on interviews. Additionally, a shareholder/equity owner dispute can result in diminished confidence on the part of lenders, suppliers, customers and employees.

Concluding Thoughts

This chapter briefly describes the various roles that an independent financial specialist can undertake during a corporate divorce. It is critical that the independent financial expert clearly understand the scope of the project he/she is being engaged to perform and, in most instances, obtain agreement of legal counsel. Keep in mind that the financial expert may need to consult with other experts including IT professionals, real estate or other specialty appraisers, or tax professionals, to facilitation completion of his or her assignment.



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V. Valuation Issues

In the context of shareholder/equity owner disputes, the valuation of the company typically poses one of the most critical issues requiring resolution. As previously noted, there are aspects of business valuation that are unique to shareholder and other equity owner disputes, which must be understood and considered by the business valuator. Failure by the valuator to consider these nuances can have a profound effect on the conclusion and create issues in resolving a dispute.

Since the value of an equity interest in a privately held business is at the heart of shareholder/equity owner disputes, it is critical to engage a qualified valuation expert. There are a number of factors that should be considered in connection with the effective use of a business valuation expert in the context of such disputes, including:

- ***The business valuator must be qualified to perform the necessary analysis and formulate an informed and meaningful opinion.*** Engaging an accredited valuation professional with experience in shareholder/equity owner disputes is almost always more effective than one who lacks the same knowledge and experience.
- ***The business valuator must offer reliable and relevant analysis and opinions.*** Any opinion of value should be based upon careful and thorough research and analysis. The approaches and methods employed in the valuation process should be commonly accepted in the valuation community and applied correctly.
- In the context of providing services in connection with pending or threatened litigation:
  - ***The valuation expert must have credibility with the court.*** One way in which credibility can be established is by researching prior cases where the expert has testified. Courts will often comment of the qualifications and reliability of the expert, providing a wealth of information relative to the consistency, thoughtfulness and thoroughness of the business valuator/expert.
  - ***The valuation expert must absolutely refrain from advocacy.*** The role of the expert is to guide the trier of fact to the truth, even if that truth conflicts with the client's position. Courts are concerned that attorneys may make the expert a surrogate advocate for the client's position, and will resolve this by appointing their own experts under Federal Rule of Evidence 706.

As one can surmise from above, the lack of diligence in engaging a qualified business valuator can create issues in connection with resolving a shareholder/equity owner dispute. The lack of a quality valuation can often prove to be a costly misstep that can lead to rendering the opinion of value useless, necessitating the need to engage another appraiser.

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Purpose of a Business Valuation

Integral to every business valuation conclusion is the purpose of the valuation. In the context of a shareholder/equity owner dispute, the business valuator may be engaged to provide an opinion of value of the subject equity ownership interest in an attempt to assist the remaining equity owners to offer a reasonable price, negotiate with the selling equity holder, or resolve a dispute relative to value.

Description of the specific interest(s) that are the subject of the valuation must be articulated clearly to result in a meaningful conclusion. The interest(s) can include equity stock (common or preferred, voting or nonvoting) of a corporation or S corporation, partnership interests (including general and limited partners), or limited liability company (LLC) member interests. It must be known if the valuation subject is a partial (or fractional) interest and the relationship of that partial interest to the entire capital structure.

A buy-sell agreement may be in place containing key provisions describing the situations (triggering events) in which an equity holder is permitted or required to buy out the ownership interest of another equity owner as well as documenting how the value of the ownership interest should be determined. Generally the mechanisms in place to determine value include an agreed-upon value, a formula approach or hiring a third-party valuation expert. When the agreement calls for a third-party valuation expert, it is common to include a description of the valuation date, standard of value, premise of value and use of valuation discounts (which should be consistent with the stated standard of value). Each of these components has a significant impact on the valuation and thus, to the extent that they are clearly defined, it should serve to minimize the likelihood of additional controversy.

In the instance where parties have not executed a buy-sell agreement with the various definitional components of the valuation specified, the shareholder/equity owner dispute can be prolonged due to the complex statues and case law surrounding each component.

The purpose of any valuation provision within a governing document or agreement is to assist in determining:

- The valuation date,
- The appropriate standard of value,
- The premise of value, and
- The appropriateness or permissibility to apply discounts for lack of control and/or lack of marketability.

The remainder of this chapter addresses the issues that can arise in the various aspects of the valuation process.

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Valuation Date

Valuation is a date-sensitive process, and any conclusion of value is effective on just a single date. As such, the date(s) on which the subject equity ownership interest will be valued is critically important because events and circumstances can arise that can cause value to vary materially from one date to another. The date of valuation influences the information available for the valuation. It is the perspective from which all analysis is performed in the valuation. In connection with a shareholder/equity owner dispute, the date of valuation can be defined in a buy-sell agreement, can be agreed to by all parties, or in the event of litigation, it is the date the complaint is filed.

It is of the utmost importance that the date of valuation be meaningful in providing an opinion of value in connection with a shareholder/equity owner dispute. Issues will arise when parties to the dispute do not agree on the date of valuation. Preparing a valuation without a reliable date, can render the opinion of value meaningless. In all instances, the authors derive the date of valuation, that is the "as of" date from legal counsel.

Standard of Value

It is not overly-complex to understand the concept of standard of value. Though labeled a "standard," it is nothing more than a definitional explanation of different, commonly-utilized types of value. However, it is one of the most controversial aspects of the valuation in the context of corporate divorce. It is incumbent upon the business valuator and the user of his/her work product to fully understand the ramifications and implications of each definition. The word "value" can take on different meanings depending on the context of the valuation assignment. Application of an inappropriate standard of value will have a direct impact on the reliability of the opinion of value.

Attorney Guidance – While it is generally the role of the business valuator to fully explain and educate the attorney as to the definition and nuances of each standard of value, it is the attorney's role to dictate the standard of value that is required in conjunction with his/her case. This is especially true where judicial history subject to legal interpretation sets the precedent.

The standards of value most commonly encountered by business valuators and users of valuation reports are:

- Fair Market Value
- Fair Value
  - Financial Reporting Value
  - State Statutory Value
- Investment Value
- Intrinsic/Fundamental Value

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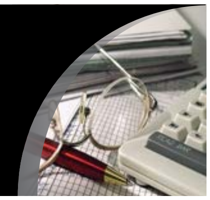

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Fair Market Value

By far the most common standard of value, fair market value, is applied in income, estate and gift tax, marital dissolution and, often, non-shareholder oppression litigation. Fair market value is defined in the *International Glossary of Business Valuation Terms* as:

> *"The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."*

The definition requires that the valuation result be driven by a hypothetical sale transaction. It stands to reason, then, that focus and attention must be given by a valuator to those hypothetical buyers and sellers, and to the concerns and issues potential hypothetical buyers/sellers might consider prior to entering into a transaction.

A key component of this definition is that a value determination based on special motivations of either a *specific buyer* or a *specific seller,* as is the case with any market data derived from "closed" deals, would not be considered fair market value. Fair market value also anticipates that both the hypothetical buyer and seller have the *ability*, as well as the *willingness*, to enter into the hypothetical transaction.

The definition of fair market value anticipates a value determination under prevalent economic and market conditions at a particular date of valuation. To assume an economic or market turnaround at a point in time beyond the date of valuation will result in a value other than fair market value. The definition also assumes that payment in the hypothetical transaction will be made in cash, or its equivalent, at the date of valuation. Thus, consideration of any deferred financing or special purchase arrangement is not appropriate when the goal is to identify fair market value. Fair market value considers the bundle of rights associated with the subject of the valuation, including attributes of control and marketability (or lack thereof).

Finally, fair market value, by definition, must allow a reasonable time for exposure in the open market. For equity ownership interests requiring longer periods of exposure, marketability (or, rather, the lack of marketability), presents a greater investment risk and, therefore, a value detriment. Often this value detriment is addressed in the business valuation process as a discount.

Investment Value

Investment value is generally defined as the specific value of an investment to a particular class of investors based on individual investment requirements. In consideration of valuing an equity ownership interest, invest-

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ment value differs from fair market value, which is not buyer- or seller-specific. Often, investment value is also referred to as ***synergistic*** or ***strategic*** value. This reference reflects the impact of those synergistic or strategic benefits one particular buyer may bring to the negotiating table in determining investment value, such as:

- An ability to enhance future operating performance,
- An ability to mitigate certain risks inherent in the subject company,
- An ability to more efficiently finance the acquisition of the subject company, and
- An ability to assimilate current operations synergistically with the subject company.

In most instances, investment value will exceed fair market value. This phenomenon is primarily the result of the supply and demand continuum for target companies. Simply put, demand for acquisition targets far exceeds available supply. As competitive bidding progresses in the negotiation process, the marketplace reveals that prospective specific buyers are generally willing to pay a premium beyond fair market value (i.e., sharing the buyer's synergistic or strategic premium) to close the deal. Additionally, anticipated post-acquisition cost reductions due to operational synergies may allow for the payment of a greater premium.

Intrinsic or Fundamental Value

Perhaps the most difficult standard of value to grasp, intrinsic value represents a specific analyst's judgment of value based on the perceived characteristics inherent in the specific investment. The intrinsic value does not contemplate the specific motivations of a particular buyer, but rather, how that one analyst's perception of the characteristics attendant to the subject equity ownership interest compares to other analysts' perceptions.

An easy way to envision intrinsic value is to consider how it might apply to a capital stock investment. Essentially, intrinsic value is that value, based on the analyst's "fundamental evaluation" of all available information, that the analyst believes reflects the "true" or "real" worth of that stock. When all analysts perceive the stock's value as the same number, the intrinsic value moves to fair market value.

The term intrinsic value is often discussed in case law; however, it is rarely defined. Attempts to utilize this standard of value in New Jersey family courts have been met with controversy.

Fair Value for Financial Reporting

As international accounting rules (including those used in the United States) move from an historical basis of accounting to a "fair value" basis of accounting, more attention has been focused on the definition of fair value for financial reporting purposes.

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In accordance with Financial Accounting Standards Board Accounting Standards Codification 820 ("FASB ASC 820"), fair value is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." FASB ASC 820 discusses, at length, fair value measurements and sets forth the following interpretive components:

- An orderly transaction is one that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual or customary for transactions involving such assets or liabilities; it is not a forced transaction.
- A fair value measurement assumes that the transaction occurs in the principal market for the asset or, in the absence of a principal market, the most-advantageous market for the asset.
- The price in the principal (or most-advantageous) market used to measure the fair value of the asset should not be adjusted for transaction costs.
- Market participants are buyers and sellers in the principal (or most-advantageous) market for the asset that are:
  a. Independent of the reporting entity; that is, they are not related parties.
  b. Knowledgeable, having a reasonable understanding about the asset and the transaction based upon all available information, including information that might be obtained through due diligence efforts that are usual and customary.
  c. Able to transact for the asset.
  d. Willing to transact for the asset; that is, they are motivated, but not forced or otherwise compelled, to do so.
- The fair value of the asset should be determined based upon the assumptions that market participants would use in pricing the asset.
- A fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally-permissible and financially-feasible at the measurement date.
- The highest and best use of the asset establishes the valuation premise used to measure the fair value of the asset. Specifically:
  a. ***In-use.*** The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use).

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b. ***In-exchange.*** The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a stand-alone basis.

- The highest and best use of the asset is determined based upon its use by market participants. As such, the fair value measurement considers the assumptions that market participants would use in pricing the asset, whether using an in-use or an in-exchange valuation premise.

Fair Value under State Statutes

In most states (including Pennsylvania), fair value is the statutory standard utilized to resolve shareholder/equity owner disputes for both dissenting shareholder and oppressed shareholder lawsuits and civil actions. Fair value is defined in the Revised Model Business Corporation Act ("RMBCA") 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."

Some courts have shown that they do not equate fair value to fair market value, while others have not. The Delaware Court of Chancery has a long-standing tradition as one of the country's leading venues of jurisprudence for the resolution of business disputes. In a number of decisions over time, including *Tri-Continental Corporation v. Battye* 74 A.2d 71 (1950), *Cavalier Oil Corp. v. Harnett* 564 A.2d 1137 (1989), and *Swope v. Siegel-Robert, Inc.* 243 F.3d 486 (2001), the Court emphasized that there is a difference between fair value and fair market value. The following chart describes the differences between the two standards.

Differences Between Fair Market Value and Fair Value[2]

Fair Market Value	Fair Value
Willing buyer	Not always a willing buyer
Willing seller	Not a willing seller
Neither under compulsion	Buyer not always compelled; seller under compulsion
Assumes a typical hypothetical buyer and seller	The impact of the proposed transaction is not considered; the concept of fairness to the seller is a possible consideration
A price equitable to both	A concept of "fairness" to the seller, considering the inability to keep the stock

[2] Trugman, Gary R. *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses.*

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Fair Market Value	Fair Value
Assumes buyer and seller have equal knowledge	No such assumption
Assumes reasonable knowledge of both parties	No such assumption
Applicable to both controlling interests and minority blocks	Applicable only to minority blocks
Applies to all federal tax valuations	The most common value standard in state dissenting and oppressed shareholder statutes

Fair market value is an objective standard, while fair value is an equitable standard. Note that in the event a buy-sell agreement exists, it may direct the business valuator to the agreed-upon standard of value. However, if the valuation assignment is related to a shareholder oppression suit, Pennsylvania law plainly provides that oppressed shareholders/equity owners are entitled to the "fair value" of their equity interest.

Selecting the correct standard of value and applying it properly is critical in a valuation assignment as each standard will yield different opinions of value. The standard of value dictates the methodologies that will be performed as well as the discounts and premiums that may be applied. This is often challenging in a litigation setting as the correct standard of value varies depending on the nature of the case. As a result, it is important that legal counsel is consulted regarding the standard to be used.

Premise of Value

In addition to defining the standard of value for an assignment, it is important to determine the applicable premise of value. The premise of value is an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation. Premises of value include either ***going concern*** or ***liquidation***.

Most often, valuation professionals work under the going concern premise of value, meaning that the existing management of the subject company will remain into the future and will maintain the character and integrity of the company. A liquidation premise would provide the net amount that would be realized if the business was terminated and the assets were sold piecemeal. Liquidation can be either "orderly" or "forced."

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Valuation Adjustments (Discounts)

Determination of the value of an equity interest requires the valuation practitioner to carefully scrutinize the specific investment characteristics and attributes inherent in the attendant equity instrument. Knowledge of these investment characteristics is critical to proper risk assessment and, thereby, producing a conclusion of value addressing these risks.

In addition to understanding the investment characteristics of a specific equity instrument, it is equally important that the valuator understand the mechanics of the commonly-used valuation methodologies under the three broad valuation approaches (income, market and asset-based). Depending upon valuator inputs into the mathematical models under the various methodologies, each has the ability to produce a valuation conclusion that differs in relation to the attendant equity interest. The difference results because of varying investment characteristics contained in the methodologies. If these investment characteristics do not parallel those of the equity interest under valuation, it may be necessary to modify the conclusion of value reached thereunder.

Most often, these modifications are reflected as discounts and/or premiums to the conclusions generated under various valuation methods. The investment characteristics most often addressed in this manner are related to control, or lack thereof, and those related to a lack of liquidity or marketability.

It is important to note that, by themselves, discounts and premiums do not exist. That is to say, these items are not traded on an open market, nor is there discernible direct evidence as to the proper level of discount or premium to use in any specific instance. In effect, "discounts and premiums" are the "fallout" of using "less-than-perfect" market data to measure value.

Nevertheless, the common acceptance of these methodologies necessitates that the business valuator utilize discounts and premiums to modify the conclusions reached thereunder to accommodate the characteristics of the equity interest under valuation. There is often no greater dollar adjustment than that attributable to the business valuator's final determination of discounts and premiums.

To the extent that a buy-sell agreement requires the application of the fair market value standard, discounts for lack of control and lack of marketability may be applied to minority (non-controlling) equity ownership interests in closely held businesses in the context of a shareholder/equity owner dispute, if application is necessary.

Whether valuation discounts should be applied in a fair value context is often subject to contentious debate in shareholder/equity owner disputes. In the event that the dispute leads to a shareholder oppression action, and the fair value standard is employed, discounts may or may not apply as treatment of discounts vary from one state to another.

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The majority of states use the fair value definition set forth in the 1984 Revised Model Business Corporation Act; however, the definition was revised again in 1999 to read:

"Fair value, with respect to dissenter's shares, means the value of shares immediately before the effectuation of the corporate action to which the dissenter objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal, and without discounting for lack of marketability or minority status except, if appropriate, for amendments to the certificate of incorporation pursuant to section 13.02."

The primary difference between the 1984 definition and the 1999 version is that the latter addresses the inapplicability of valuation discounts. Few states have integrated this update into their statutes, but the new definition has been referenced in several shareholder/equity owner dispute cases as support for the exclusion of valuation discounts. While there is currently no clear consensus among states on whether fair value calculations should include the application of discounts, the trend appears to be moving towards excluding them.

Depending on the jurisdiction, the following has been observed when applying fair value:

- Disallowing both discounts;
- Allowing both discounts;
- Allowing only a discount for lack of control only; and
- Allowing only a discount for lack of marketability.

In Pennsylvania it has been observed that in employing the fair value standard, valuations appear to employ fair market value without the consideration of either discount for lack of control or lack of marketability.

In *Delaware Cavalier Oil Corp. v. Harnett,* the Delaware Supreme Court held the following:

"Discounting individual share holdings injects into the appraisal process speculation on the various factors which may dictate the marketability of minority shareholdings. More important, to fail to accord to a minority shareholder the full proportionate value of his shares imposes a penalty for lack of control, and unfairly enriches the majority of shareholders who may reap a windfall from the appraisal process by cashing out a dissenting shareholder, a clearly undesirable result."

The decision in the *Cavalier* case illustrates the concept of fairness to the seller. Applying discounts would unjustly reward the majority shareholders.

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Concluding Thoughts

Valuation is critical to any potential shareholder/equity owner repurchase transaction. This chapter summarized the valuation subtleties that should be considered in connection with shareholder/equity owner disputes. Issues can arise in many areas of the valuation, which can pose a serious risk as to the relevance of the opinion of value. It is important that legal counsel assess the valuation expert's understanding of these issues and set the necessary framework to derive a meaningful and relevant conclusion of value.

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VI. Forensic Issues

Oppression

In determining whether oppression has taken place in conjunction with any shareholder/equity owner dispute, it is first necessary to define that term as it is applied in the context of these cases. Unfortunately, there is no common definition. Because oppression claims are specifically defined by each state's particular statutory and case law, there is no single standard across the country for determining when "oppression" has occurred. Many states vary the definition and, in some states, statutory prohibitions against oppression do not actually define oppressive conduct.

In other states, statutes do set forth particular definitions of oppression. For example, one state's shareholder oppression statute defines "willfully unfair and oppressive conduct" as "a continuing course of conduct or a significant action or series of actions that substantially interferes with the interests of the shareholder as a shareholder." This statutory definition leaves room for interpretation (as do many).

It is clear from a variety of court decisions that the term is to be interpreted broadly with a significant reach into a variety of potentially harmful actions by the party committing the oppression. A partial listing of case findings (non-exhaustive) that set out common examples of oppression include:

- Failing to pay dividends when the corporation has the financial wherewithal to do so,
- Causing the corporation to pay the majority shareholders/equity owners compensation that is excessive and unfair to the minority and/or the corporation,
- Paying the majority shareholders/equity owners compensation amounting to a de facto dividend, to the exclusion of the minority shareholders
- Denying shareholders/equity owners participation in management of the corporation or a voice in decision-making processes,
- Attempting to implement an unfair stock redemption plan favoring majority shareholders/equity owners
- Failing to provide the minority shareholder/equity owner the documents necessary to properly evaluate his/her interests when selling his/her shares,
- Not allowing minority shareholders/equity owners to participate in capital calls or otherwise protect themselves from dilution of their equity,
- Using corporate funds to pay the personal expenses of other shareholders or related parties (i.e., family),

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- Failing to provide financial statements or other information that shareholders/equity owners have a right to receive,
- Engaging in acts designed to freeze the minority shareholder/equity owner out of the corporation rather than give him/her a fair share of his/her investment, and
- Denying a shareholder/equity owner any return on his/her equity while refusing to buy out his/her shares for Fair Value.

Obviously, it is not possible to prepare a comprehensive listing of all activities that might constitute shareholder owner oppression. However, as noted earlier, it appears that the term is intended to embrace a very wide reach of actions that work to the detriment of other shareholders and equity owners.

Keep in mind that while most shareholder oppression cases work to protect minority or non-controlling equity ownership positions from the actions of the controlling interest holders, it is also possible to see similar actions brought in equal ownership (50/50) arrangements.

The obvious result of the common activities, as determined by the courts in the examples above, is the likely outcome that the "alleged" oppressed party suffered due to the actions taken by the majority equity ownership group. Measuring this suffering (from an economic standpoint), frequently requires forensic principles and procedures to be employed to determine the breadth and depth of the economic reach of the alleged malfeasance.

Role of the Forensic Specialist

The specific forensic procedures, and scope of the overall forensic effort, will depend primarily on the types of actions at issue in any case. A forensic examination can be used to properly determine the economic effects of:

- Excessive compensation, salary, and/or fringe benefits,
- Paying personal expenses of controlling equity owners with business funds,
- Inappropriately making personal use of business entity's assets,
- Inappropriately making personal use of business entity's employees,
- Historical financial performance when controlling equity owners misstate actual financial performance,
- Verification of the independence and objectivity of the Board of Directors, ensuring that they are not simply agreeing with the equity owners on every decision,
- Restricting cash flow distributions and dividend payments,

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- Assessing the businesses cash flow distribution and dividend-paying capacity,
- Normalization of historical financial and operating information to allow for an appropriate valuation that does not offer minority equity owners a depressed and unfair price for their shares, and
- Assessing the performance and economic effects of nepotism where family members and friends have been hired by the majority owners, especially in the management group.

The procedures that are most often applied in circumstances such as these are somewhat akin to a fraud analysis. Given the impropriety of the actions by the controlling equity owners, and the fact that certain economic gains inure to that group at the expense of the non-controlling group of equity owners, the outcomes are very similar. Such forensic procedures are even more critical in circumstances where the offending party is found to be carefully covering his or her "tracks". In these instances, the differences between a fraud assignment and a normal forensic engagement are virtually nil. Given this similarity, it is helpful to look at the different types of fiscal malfeasance that may be rooted in the alleged bad behaviors by the controlling equity owner group.

Types of Malfeasance

The specificity of the harmful activities and the methodologies by which the alleged perpetrators attempt to cover their trails can lead to an endless number of methods and nuances by which that activity can be hidden from plain sight. However, most treatises and articles on fraud (and forensic and investigative accounting), use three common categories to establish a broad framework of similar activities. These categories, embraced by the Association of Certified Fraud Examiners (ACFE), include Financial Statement Fraud, Asset Misappropriation and Corruption. The first two types of malfeasance are most common to minority shareholder oppression, and are described in more detail below.

Financial Statement Improprieties

As the name implies, financial statement improprieties are devices used to provide misinformation, and which begin and end with purposeful manipulation and misreporting of the financial results of the organization. The general purpose of such manipulations and misstatements are generally twofold. First, the intent is usually to lead the financial statement readers or users to reach a conclusion from those statements that conveys an inaccurate assessment and interpretation of the financial performance of the organization. The second aspect is integral to the first, in that, oftentimes, financial statement manipulations and misstatements reflect positive actions by the controlling equity owners to hide improprieties from the non-controlling equity owner(s) or other readers or users.

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Financial statement improprieties are the deliberate misrepresentation of financial information via intentional misstatements or omissions (amounts or disclosures). While the least-common (9% of cases) of the three major categories of fraud, financial statement fraud accounts for the highest median loss ($1 Million per occurrence).[3]

In conjunction with exploring majority equity owner malfeasance from a forensic perspective, financial statement improprieties can be used to cover a number of shareholder oppression activities, including, for example:

- Misrepresenting financial results to non-controlling equity owners,
- Misstating financial performance to enhance managing shareholder performance bonuses,
- Hiding excess compensation and earnings of the controlling equity owners by misclassifying certain pay-related information,
- Hiding compensation to relatives and friends who may have been employed by the company by the controlling equity owners, and
- Hiding payment of personal expenses by failing to disclose related-party transactions.

Financial statement misstatement is generally undertaken in order to improve and/or smooth financial results, such as income, earnings per share or earnings before interest taxes depreciation and amortization (EBITDA), and is commonly committed by misstating assets and revenues and/or liabilities and expenses. Misstatements often artificially improve the results in a weak period, but may also occur in strong periods via creation of reserves/allowances that can be used as "cookie jars" in weaker periods. As noted, misstatements may be used in poor performance periods to prop up those numbers relevant to the determination of the controlling equity owner's bonus.

Such deliberate misstatements may be achieved by completely fabricating assets or liabilities or by recognizing transactions in the wrong period, but are often effected more subtly, via manipulation of various financial estimates. Some common estimates that are subject to judgment, and accordingly, manipulation, include: allowances for doubtful accounts, inventory reserves, depreciable lives/methods, contract accounting and various accruals for items such as warranties, commissions and environmental issues.

In some circumstances, manipulation of the financial statement is used to cover up embezzlement within the organization or may be driven by bonus incentives. These types of manipulations often result in no direct financial benefit to the controlling equity owners, excepting maintaining leadership positions within the company.

[3] ACFE Report to the Nations on Occupational Fraud and Abuse – 2014 Global Fraud Study

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Asset Misappropriation

Overwhelmingly the most common category of improprieties, asset misappropriation, encompasses the misuse, theft and misdirection of an organization's assets. In almost every case of asset misappropriation by majority owners, the stolen assets/property(ies) are intended to directly benefit the controlling equity owners.

Many "large loss" asset thefts start with smaller amounts being taken from the business or organization. As those committing the malfeasance gain confidence that the assets have been garnered without notice, more brazen behaviors often take over and serve to increase the amount of assets misused or stolen. Many business equity owners and organizations view asset misappropriation as a cash issue. To be sure, cash is the asset of choice for occupational theft. However, inventory, scrap, fixed assets and supplies all lend themselves to potential exposure to asset theft and misuse fraud.

In the experience of the authors, most instances of majority shareholder/equity owner asset misuse does not necessarily rise to the level of outright, and blind, theft. In most instances, these assets are misdirected to the benefit of the majority shareholders/equity owners in the open, under the assumption that the perpetrators are doing nothing wrong, and they are due these general fringe benefits. Such brashness often makes identification of company asset misuse in these circumstances easier and less-expensive to detect using forensic procedures.

The process of asset misappropriation can take numerous different roads to the same end – theft. While most asset theft is fraud (predicated upon an intent to actually steal the desired asset), in the context of corporate divorce and shareholder/equity owner disputes, the issue more often turns to a diversion of funds.

Typically, any misuse of a corporate asset can be characterized as asset misappropriation. To that end, numerous organizational assets can be misused in any number of ways by the controlling equity owners. Often, that misuse has a direct relationship to the type of asset involved in the scheme. Those assets that lend themselves particularly to theft or misuse include: real estate (apartments, vacation homes and lodging facilities); transportation (planes, vehicles and boats); and office equipment, including computers and specific application tools.

Examples of various asset misuse schemes include:

- *Acquiring unnecessary assets* – In this instance, there is no legitimate business purpose for acquiring the asset. Once acquired, if the asset is used by senior executives, the result may be disguised compensation.
- *Purchasing overpriced assets* – In this instance, the amount paid for the asset far exceeds its utility and value to the business. Often transacted with a related party, without disclosure, such devices result in drawing out and misdirecting corporate funds.
- *Bargain asset dispositions* – In this instance, assets are sold, again, to related parties, at bargain prices. Continued use by the related party or sale by that party for fair value results in asset misuse.

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Fraudulent Disbursements

Fraudulent disbursements can be a descriptive title for a wide variety of asset misappropriation. Some of the commonly encountered devices observed by the authors in conjunction with the rendering of forensic services include more significant fraud-like schemes. With respect to majority shareholder/equity owner malfeasance and improprieties, the extent of fraudulent disbursements encompasses excessive expense reimbursements, payments made by the company for personal expenses and bonuses, and commission payments made for "overstated" performance.

Forensic Accounting and Fraud Engagements

In today's business climate disputes are prevalent, whether due to misunderstandings, mistakes or deliberate misrepresentations. For better or for worse, many of these disputes are settled via our legal system, or merely with threats from shareholders/equity owners of taking the case to court. In order to understand the difference between forensic accounting and fraud, it is helpful to know basic definitions and distinguishing factors.

Definitions

- Forensic – belonging to, used in, or suitable to courts of judicature or to public discussion and debate (Merriam Webster)
- Accountant – a person concerned with the maintenance and audit of business accounts and in the preparation of consultant reports in tax and finance (Collins Dictionary)
- Forensic Accounting – the use of professional accounting skills in matters involving potential or actual civil or criminal litigation, including, but not limited to, generally acceptable accounting and audit principles; the determination of lost profits, income, assets, or damages; evaluation of internal controls; fraud; and any other matter involving accounting expertise in the legal system (ACFE)
- Fraud – intentional perversion of truth in order to induce another to part with something of value or to surrender a legal right, an act of deceiving or misrepresenting (Merriam Webster)
- Fraud Examination – a methodology for resolving fraud allegations from inception to disposition. More specifically, fraud examination involves obtaining evidence and taking statements, writing reports, testifying to findings, and assisting in the detection and prevention of fraud (ACFE)

Most fraud examinations involve forensic accounting, but not all forensic accounting is fraud examination.

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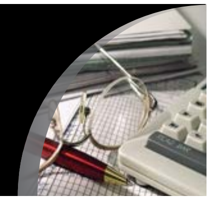

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Distinct Difference in Approach of Forensic versus Audit Engagement

Keep in mind that forensic analysis differs markedly from an audit of the company's financial statements. An auditor's responsibility is to express an opinion on financial statements based on an audit. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

A forensic accountant's scope tends to be more-specific and focused; procedures are generally more exhaustive; the goal is often to defend and/or refute in an advocacy arena rather than to express an opinion. A forensic accountant uses a very different approach in coming to a conclusion than a traditional auditor. Forensic accountants look to analyze data, form a hypothesis, test the hypothesis, and refine and amend the hypothesis according to results.

Forensic and Fraud Procedures

When a Certified Public Accountant (CPA) is serving as an auditor, focus is on performing procedures designed to gain reasonable assurance that selected financial statement balances are not materially misstated. Accordingly, the approach is broad, covering all significant financial statement categories. An auditor employs both analytical and detailed procedures in order to accomplish his/her objective.

While performing forensic or fraud services, a CPA may employ analytical procedures in order to identify potential issues; however, once the issues are identified, the detailed work performed tends to be substantially more-comprehensive than in an audit, as the objective is not subject to the concept of materiality, but is routed in proving and/or specifically quantifying amounts. The scope of work and type of procedures performed in such engagements is completely customized for the specific circumstances.

CPAs also utilize evaluations of internal control within the organization. This can be accomplished through review of documented control procedures; interviews with management, staff and employees who directly handle the financial obligations of the organization; and testing of various controls to determine if they are followed, and how effective they are. Controls related to check signing, segregation of duties and transaction approvals are common documented control procedures. Testing internal controls can provide a gateway to vulnerable areas where fraud may be more susceptible. It is important to note that it is the organization's responsibility to design and implement controls to prevent and detect fraud. The CPA's objective is to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether by error or by fraud.

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The primary purpose of a CPA engaged for forensic or fraud services is to gather evidence. Evidence can be obtained and maintained in various forms, which include documentary, client testimonial, observational and any other physical evidence. The fraud examiner will use this evidence in constructing a case to support or refute a specific claim.

Selecting an Accountant for Forensic and/or Fraud Services

There are many important considerations to be made when selecting a CPA for forensic or fraud services. First, the purpose of the engagement must be determined. The organization needs to consider the specific need, whether it is for an expert witness, counsel, or is preventative in nature.

An expert witness is someone who has exemplary character, coupled with specialized knowledge and a prolific skill set. He/she is someone that can be counted on to make a case, as well as be credible to the trier of fact. This examiner must be a reputable witness on the stand, truthful under oath, calm and collected under the pressure of hostile examination, and display an ability to make complex subject matter understandable to the person trying the case. If an organization is searching for a forensic accountant for the purposes of counsel, they will search for someone with the intelligence to locate the truth and create a case on paper.

CPAs can also be used in a preventative role with respect to fraud. CPAs are qualified to assist companies in being proactive and to implement preventative measures which deter fraud from occurring. Often, these engagements will be of a consulting nature and will lead to various control-related recommendations. The ultimate goal is for the CPA to assist the company in attaining enhanced anti-fraud measures, which ultimately lead to fewer opportunities for fraud to occur; more timely detection of any fraud which does occur; and consequently, less monetary loss due to fraud.

In general, CPAs qualified to serve in this capacity are creative, personable and honest. They are able to keep confidences and perform their tasks using sound professional judgment. The nature of these services requires a persistent work ethic in order to ultimately uncover and analyze information that will support or refute specific claims. These experts are expected to apply these characteristics in every aspect of their work to provide a high-quality product and service to those who are engaging them.

Certifications

- Certified Public Accountant (CPA) – The requirements, which are set by each state board of accountancy, include: completing a program of study in accounting at a college or university; passing the Uniform CPA Exam; and obtaining a specific amount of professional work experience in public accounting (the required amount and type of experience varies according to licensing jurisdiction).

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CPAs provide a wide range of services and are employed in public accounting and other professional services firms, business and industry, government and education. CPAs in public practice are engaged by their clients for a variety of services including accounting, auditing, tax, personal financial planning, technology consulting and business valuation. CPAs employed in business, industry and government are likewise responsible for various activities, including accounting and financial reporting, implementing and managing internal controls and information systems, compliance with tax and other laws and regulations, and other areas of business and financial management.

- Certified Fraud Examiner (CFE) – The CFE credential denotes proven expertise in fraud prevention, detection and deterrence. CFEs are trained to identify the warning signs and red flags that indicate evidence of fraud and fraud risk. CFEs around the world help protect the global economy by uncovering fraud and implementing processes to prevent fraud from occurring in the first place.

- Certified in Financial Forensics (CFF) – The American Institute of Certified Public Accountants (AICPA) established the Certified in Financial Forensics (CFF) credential in 2008 for CPAs who specialize in forensic accounting. The CFF credential is granted exclusively to CPAs who demonstrate considerable expertise in forensic accounting through their knowledge, skills and experience. The CFF encompasses fundamental and specialized forensic accounting skills that CPA practitioners apply in a variety of service areas, including bankruptcy and insolvency, computer forensic analysis, family law, valuations, fraud prevention, detection, and response, financial statement misrepresentation, and economic damages calculations.

A Word of Caution

The discovery of fiscal malfeasance and fraud often leads to powerful emotions. The issue is even more difficult when the parties are related through equity ownership. How one reacts to the discovery is important to the shareholder/equity owner dispute resolution. Communications of an accusatory type will likely prove less than helpful. It is important to facilitate a plan of communication to ensure that the affected parties have an opportunity for rebuttal and defense. Reasonable evidence garnered through the forensic process should lead to an opportunity to make necessary adjustments to the historical information so shareholder/equity ownership valuations can be more accurate and the economic effects of prior fiscal malfeasance can be corrected and quantified for purpose of negotiation and settlement.

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Concluding Thoughts

Forensic accounting engagements are complex, time-intensive, and always completely-customized and designed for specific-purpose applications. Selecting a forensic specialist that you or your client will engage for such services is an important decision. In some high-profile circumstances, only a top-flight, fully-credentialed individual will be acceptable. However, in many smaller cases, an intelligent, experienced, persistent and creative forensic specialist may be just as capable and significantly more cost-effective.

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VII. Recent Court Cases

The following is a sampling of recent corporate divorce cases decided in various jurisdictions. It is not intended to be an all-inclusive representation of current case law.

Madugula v. Taub, 2012 WL 5290285 (Mich. Ct. App. October 25, 2012)

The case included three shareholders who entered into a stockholders' agreement, under which Taub became president, secretary, and treasurer and the other two shareholders, including Madugula, became vice presidents. The agreement included a supermajority provision requiring approval by the holders of 70% of the corporate stock for, among other things, material changes in the nature of the business, compensation for the shareholders, or methods of determining compensation for the shareholders. Madugula continued to work for the company, but the third shareholder exercised his right under a buy-sell agreement to withdraw from the company.

Taub changed the company's focus to marketing a new product, which Madugula claimed was a major departure and material change. Taub subsequently terminated Madugula's employment, though Madugula maintained his board position and interest in the company and continued to receive dividends from the company as a shareholder.

Madugula's complaint asserted counts of shareholder oppression, breach of duty of good faith and common-law fraud and misrepresentation. Madugula sought damages, the removal of Taub as a director, the appointment of a receiver to protect the value of his stock, an accounting of the company, and all other relief to which he was entitled in equity or law.

The jury determined that Taub had engaged in willfully unfair and oppressive conduct that substantially interfered with Madugula's interests as a shareholder and awarded Madugula economic damages. It further concluded that Taub was required to buy Madugula's stock. The Court entered a judgment in Madugula's favor.

On appeal, the Court affirmed in an unpublished opinion concluding that Taub's behavior was willfully unfair and oppressive. Additionally, there was evidence of oppression as Taub violated the supermajority provision in the shareholders' agreement, and that termination of Madugula's services was evidence of oppression.

Ballard v. Robertson, 733 S.E.2d 107 (S.C. 2012)

Four shareholders entered into a stock purchase agreement. At that time, the corporation had issued only 40,000 shares of stock (all of which were owned by Ballard), although the Articles of Incorporation authorized

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the issuance of 100,000 total shares. Under the Agreement, the individual Appellants paid Ballard $1,000,000 "in exchange for 20,000 shares of Ballard's 40,000 and [received] from the corporation [60,000] additional shares so that Ballard [would] hold 20% of the stock and the other 80% [would] be held by the other three shareholders." The agreement also detailed the duties of each of the parties.

After the development project undertaken by the business did not achieve expected results, the three shareholders requested that Ballard return some or all of the money he had been paid or return his 20,000 shares to the corporation and cease involvement with the development project.

Ballard subsequently was removed as a director at the first shareholders' meeting a few months later. At that same meeting, however, all three of the other shareholders were elected to the board and appointed as officers. Immediately thereafter, the individual Appellants – with the dissent of Ballard – approved the issuance of an additional 900,000 shares. The issuance would be in direct conflict with the Articles of Incorporation, which only authorized 100,000 shares, and the Agreement, which stated Ballard would ultimately own 20% of the corporation. No motion was made to amend the Articles.

Realizing this increase in shares would dilute his holdings to 2%, Ballard initiated this lawsuit, alleging a violation of the Agreement and seeking an injunction preventing the issuance of the additional stock.

In response, the three shareholders counterclaimed for fraud, breach of contract, breach of contract accompanied by a fraudulent act, and promissory estoppel.

After discovery, Ballard amended his complaint to include shareholder derivative claims that the individual shareholders had breached the Agreement with respect to duties owed to the company, as well as allegations of oppression of the minority shareholder. The three shareholders counterclaimed for fraud, breach of contract, breach of contract accompanied by a fraudulent act, negligent misrepresentation, and violation of South Carolina Code in connection with the sale of securities.

A jury trial commenced, but the jury was discharged when the three shareholders dismissed their counterclaims with prejudice. Thus, only Ballard's equitable claims remained. The Circuit Court found sufficient evidence of oppression and ordered the three shareholders to purchase Ballard's stock at fair market value. Additionally, the Court ordered that the individual Appellants place 60,000 of their shares in escrow pursuant to the South Carolina Code (2006). This appeal followed.

On appeal, the Court found a clear intent by the Appellants to "freeze out" Ballard and exclude him from involvement with the company and the benefits of ownership. The Circuit Court's decision was affirmed.

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Colgate et al v. The Disthene Group, Inc., 2013 WL 691105, 85 Va. Cir.286

In August 2012, Judge Jane Marum Roush, sitting by designation in the Circuit Court of Buckingham County, issued a comprehensive letter opinion in this case.

Gene Dixon, Jr. and his son, Guy, owned all of the voting stock of The Disthene Group, Inc., a successful and diversified business operating in Buckingham County, Virginia. Among other enterprises, Disthene owned the Cavalier Hotel Corporation in Virginia Beach and Kyanite Mining Corporation, the world's largest producer of the minerals kyanite and mullite. Gene and Guy consistently elected themselves and their allies as officers and directors of Disthene and its subsidiaries. Most of the non-voting shares not owned by Gene and Guy were owned by descendants of the company's founder, Gene Dixon, Sr., who were relatives of Gene and Guy.

Minority shareholders owning 42% of the outstanding shares brought suit, alleging that Gene and Guy had engaged in a pattern of oppressive and fraudulent conduct designed to disadvantage the minority shareholders and had misapplied and wasted corporate assets. Gene and Guy generally denied the allegations and relied on the business judgment rule, which insulates directors of a corporation who "discharge their duties in accordance with good faith business judgment of the best interests of the corporation," to justify their actions.

In their lawsuit, the plaintiffs sought the extraordinary remedy of corporate dissolution as provided by the Virginia code. A circuit court is empowered to dissolve a non-public Virginia corporation if it finds, among other things, that the directors have acted in a manner that is illegal, oppressive or fraudulent, or if it finds that corporate assets have been wasted or misapplied. The Supreme Court of Virginia has held that, in this context, "oppressive" means "a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely."

The business judgment rule provides a safe harbor that shields a director from liability for actions taken (or not taken). Application of the rule presumes that the director acted in absence of personal interest, made an informed decision based on a reasonable effort to become familiar with the facts, acted on a reasonable belief that the decision served the interest of the company, and acted in good faith. Because the rule does not apply unless the director has exercised his or her independent, good-faith business judgment, the rule does not offer protection when the director fails to engage in informed decision-making or when the decision is made in the best interests of the director as an individual, rather than of the corporation.

The judge found that the plaintiffs had engaged in a long-standing practice of oppression of the minority, had wasted and misapplied corporate assets, and had engaged in misrepresentations and half-truths with respect to the efforts of some minority shareholders to redeem their shares. As a result, the judge agreed to provide the remedy mandated by Virginia law; she ordered judicial dissolution of Disthene.

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Gene and Guy appealed, but the case settled in August 2013 before the Virginia Supreme Court could review the matter.

While it is not necessarily the law of the Commonwealth of Virginia, it provides one judge's thought-provoking conclusions in this area of corporate law.

A significant portion of judge's letter opinion was devoted to setting forth and analyzing common techniques of the oppression of minority shareholder. These "squeeze out" techniques include withholding dividends or keeping dividend payments artificially low in order to force minority shareholders to sell the shares at considerably less than actual value and awarding unreasonable jobs, salaries, pay-raises and bonuses to the majority shareholders or their family members.

The opinion reassessed a substantial portion of the body of law governing the duties of majority shareholders in closely-held corporations.

Owen v. Cannon, C.A. No. 8860-CB (Del. Ch. June 17, 2015)

In this recent case, the stockholder plaintiff was awarded nearly $16 million more for his shares than the merger consideration. The opinion follows recent decisions crediting and utilizing management projections created in the ordinary course of business pre-merger for valuation purposes, and declining to utilize projections developed in connection with litigation.

The appraisal action was brought by Nathan Owen, who at the time of the merger was the largest stockholder of Energy Services Group Inc. (ESG), a closely-held company sold in May 2013. The merger was orchestrated by ESG's two other large shareholders, Lynn Cannon and Bryn Owen, who voted to approve the merger over the stockholder plaintiff's objection, and after giving him just one-day notice of a special board meeting at which the merger was approved.

Cannon had replaced Nathan Owen as ESG's president in 2009, but the company continued making significant profit distributions to Nathan Owen after he no longer had a day-to-day role at the company. Cannon testified that he was interested in effecting the merger quickly in order "to stop the hemorrhage" of these distributions paid to Nathan Owen.

After the merger was completed, Nathan Owen brought an action seeking appraisal of his 35% ownership stake in the company and also asserting claims for breach of fiduciary duty against Cannon and Bryn Owen.

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To determine the "fair value" of Nathan Owen 's shares, as required under the Delaware appraisal statute, a discounted cash flow ("DCF") methodology was applied by both parties at trial. Although the parties agreed on the relevant methodology for calculating fair value, they disagreed on the inputs into the DCF model.

The issue in applying the DCF model was which set of projections should be utilized in the DCF analysis – management projections that had been developed by Cannon and the company's financial advisers prior to the litigation, or projections developed by the defendants' experts in connection with the litigation.

Noting that "Delaware courts place great weight on contemporaneous management projections," the chancellor accepted the management projections relied upon by the plaintiff because the projections were the product of a "deliberate" and "iterative" process and prepared by Cannon, who was "extremely well-informed" about ESG and its potential growth. The chancellor also placed "great weight" on the fact that these projections had been provided to lenders prior to the merger in connection with the company's efforts to raise money to buy out the stockholder plaintiff 's shares.

At the same time, the chancellor rejected the more pessimistic projections used by the defendants, which lacked the same indicia of reliability as the ordinary-course management projections. Noting that the Chancery Court is "generally skeptical" of projections created by experts for the purpose of litigation, the chancellor concluded that the defendants' "after-the-fact projections...created for purposes of this litigation are tainted by hindsight bias."

The chancellor addressed the breach of fiduciary duty claims, and determined that the merger was not the result of fair dealing, due to the impermissibly-short notice that the defendants provided of the meeting to consider the merger and their failure to accommodate Nathan Owen's request to delay the meeting.

The Chancery Court has established that it will scrutinize the source and process for developing company financial projections, the purpose for which they were developed, and their application in valuation analyses when determining the fair value of appraised shares.

Adler v. Tauberg, 881 A.2d 1267 (Pa. Super. 2005)

A Pennsylvania Appellate Court upheld an Order of the Court of Common Pleas of Allegheny County appointing a 50%-shareholder (Adler), director and president of a closely-held Pennsylvania corporation, as custodian to manage the business affairs of the corporation after finding oppression.

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At trial, Adler sought appointment of a custodian on the basis of the Defendant's alleged illegal, oppressive and fraudulent conduct, causing the assets of the closely-held Pennsylvania Corporation to be misapplied and wasted. Adler further alleged the Defendants wrongly attempted to issue stock and change the rules of governance of the corporation to his detriment. In granting Adler's motion for appointment of a custodian, the trial court concluded, inter alia, appellants "had unjustly exercised authority and power over [Adler] with respect to the corporate affairs of the Corporation."

On appeal, the Defendants argued the trial court record did not support the need for the appointment of a custodian, as the evidence presented was insufficient to sustain a finding they had acted illegally, oppressively or fraudulently within the meaning of the statute.

The Court came to the following factual conclusions:

1. The three other directors were attempting to issue stock and change the rules of corporate governance to the detriment of the corporation and Adler, who was a director and president of the corporation.
2. Beginning in October of 2002, the Defendants began to request that Adler retire from the practice and his position as president.
3. The Defendants initially demanded that Adler's salary be reduced by one-third, then demanded that his contractually-guaranteed salary be revoked and his compensation be tied to his production.
4. The other members of corporation attempted to divert patients from Adler.
5. On November 5, 2003, the other shareholders attempted to issue corporate shares to another doctor. When the corporation's counsel advised that a prior written agreement restricting the transfer of corporate shares may have precluded the issuance of these shares, the vote was tabled.
6. On November 18, 2003, the Defendants, each owning 25% of the shares, voted to increase the number of board members from 3 to 4, and fill the seat with another doctor. The Defendants then voted to make themselves officers and pay each of themselves an additional $50,000 for serving as officers. This had the effect of reducing Adler's compensation by $37,500.
7. The Defendants then fired the corporations' long-time legal counsel, replacing him with their attorney.
8. The Defendants approved a resolution that paid their attorney's fees with corporate funds.
9. The Defendants effectively removed Adler's power to write checks on the corporation's bank accounts and wrote corporate checks for items with which Adler did not agree.

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As a result of considering the evidence, the Trial Court concluded that the ongoing disagreements between the parties negatively affected the functioning of the corporation and could have endangered patient care.

In deciding the appeal, the Superior Court of Pennsylvania Appellate Court held that under 15 Pa.C.S. §1767, a trial court may appoint a custodian for a corporation upon application of a shareholder when: "[i]n the case of a closely-held corporation, the directors or those in control of the corporation have acted illegally, oppressively or fraudulently toward one or more holders or owners of 5% or more of the outstanding shares of any class of the corporation in their capacities as shareholders, directors, officers or employees."

The Court noted that oppressive conduct in this case took the form of freezing out a minority shareholder by removing him from his various offices or by substantially diminishing his power or compensation.

The Court recognized that there are three different definitions of "oppressive" conduct utilized by Courts throughout the country. They are:

1. Oppression as 'burdensome, harsh and wrongful conduct, a visible departure from the standards of fair dealing and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely;
2. Oppression is linked directly to breach of the fiduciary duty of good faith and fair dealing majority shareholders owe minority shareholders, a duty that many courts recognize as enhanced in a close corporation setting; and
3. A third view ties oppression to frustration of the reasonable expectations of the shareholders.

The Court found that Pennsylvania employs the "reasonable expectations of the shareholders" test, which is the same test used by New York and New Jersey Courts. The Superior Court upheld the trial court's findings that Adler was oppressed. As such, it affirmed the trial court's appointment of a custodian to manage the day-to-day affairs of the corporation.

This decision is important for three reasons. First, the Court found that a 50%-owner was found to be an oppressed minority shareholder despite the fact that he controlled half of the company. The Court recognized that although Adler held half of the stock, he was being controlled by the other two shareholders who collectively owned the remaining 50% of the corporation's shares. Second, a custodial receiver may be appointed pursuant to Pennsylvania law if oppression or deadlock is found. Third, the Superior Court used the "reasonable expectations of the shareholder" test when determining shareholder oppression.

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Staiger v. Holohan, 100 A.3d 622 (Pa. Super. 2014)

A Pennsylvania appellate court found that a trial court could order the dissolution of a profitable Pennsylvania Limited Liability Company ("LLC").

Plaintiff Staiger and Defendant Holohan formed two Pennsylvania LLCs. Staiger lent one of the LLCs $165,000, to be used as start-up capital. The members agreed, in writing, that Staiger would be repaid the start-up money within five years. Both men owned 50% of both LLCs.

Both LLCs' operating agreements contained identical language, which set forth that the members have the authority to make business decisions, and the decisions of a majority are controlling. Shortly after forming one of LLCs, the members executed an agreement which provided that another unnamed LLC of Holman's was to manage one of the LLCs for a fee. The initial term was five years, and would then continue for two additional five-year periods.

The business relationship between Staiger and Holohan deteriorated to the point where, in 2006, they agreed in a series of emails to dissolve their partnership. Despite agreeing that they no longer wanted to continue doing business together, the two partners were unable to negotiate a buyout. Since that point, Holohan continued to unilaterally operate both companies, to the extent that Staiger neither received any further money from the businesses, nor information regarding their operations. Holohan refused to repay Staiger for his initial investment as was agreed to by both parties, and Holohan authorized the LLCs to pay for his personal legal fees without Staiger's consent.

Despite the fact that the two LLCs are profitable, the Court ordered a dissolution pursuant to 15 Pa. C.S. §972. In support of that decision, the Court reasoned that there was "deadlock" amongst the members as both parties each owned half of the companies. As such, neither member could unilaterally make management decisions without running afoul of the operating agreements which required "majority rule." The Court found that Staiger presented evidence that he was wrongfully excluded or "frozen out" from managing the LLCs, and reasoned that Holohan's unilateral decisions to have the LLCs pay his personal legal expenses and fees violated the operating agreement (which required majority approval).

This decision is important because it provides Pennsylvania trial court with guidance as to when they should order a judicial dissolution pursuant to 15 Pa. C.S. §972. Further, the Court did not permit the oppressor to use the fact that the LLCs were profitable as a bar to dissolution.

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Conclusion and Practical Considerations

Shareholder and equity owner disputes are not going to disappear. Understanding that a great deal of the assistance that can be provided by professionals (both within and without the legal profession) begins with an appreciation of the personalities of the equity ownership group and that group's interaction dynamics will go a long way in moving these types of emotional engagements forward. Once advisors have a feel for the personal elements of the parties, attention can turn to how best to attempt resolution. As noted throughout the materials, that mission is best accomplished with an even temperament, making sure that the advisor group does not add fuel to an already incendiary situation.

The primary course for seeking resolution options begins with careful review of governing documents, including all equity owner documents (such a shareholder agreements, limited liability company member agreements, partnership agreements, buy-sell agreements, employment agreements, non-compete agreements and other contractual agreements) that could affect the parties at issue, as well as all corporate or business entity minutes.

Once all relevant documents are reviewed, counsel can then begin to develop a strategy to address the specific needs of his or her client to attain a fair solution to the matters at issue. Considerations at this stage will include an assessment of tactical options, which might include the following:

- Do nothing at the current time and use delay as a strategic tool,
- Cause the opponent's side to take action, forcing them to react by spending financial resources and time,
- Create a number of attack points, or fronts, to which the opponent's side must respond,
- Call for shareholder/equity owner meetings,
- Call for Board of Directors meetings,
- Call for a special accounting,
- Call for mediation,
- Call for arbitration,
- Begin a process to invoke an equity owner buy out process,
- Begin a legal suit,
- Call for sale of the company, and
- Call for dissolution of the company.

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These are just a few of the strategic elements of consideration that can be undertaken by counsel in planning an overall strategy for moving forward in attempt to seek resolution of these matters. As variations and additional opportunities arise, making the entire process fluid, counsel can modify strategy as appropriate to meet his or her client's needs.

On the opposite end of preparation is the need to assess, as best possible, the opponent's potential and probable tactics so a defensive posture can be devised and offered as a counter. Part of this process should include an accurate and honest self-evaluation, not only of the strengths and weaknesses of the tactics adopted on behalf of the client represented, but also those strengths and weaknesses possessed by the opponent's side.

It is critical in this process that legal counsel engage independent and competent outside financial advisors. The selection of which advisors should be engaged depends upon the facts and circumstances of the case, the desires and wishes of the client, and the ultimate expert evidence that might be necessary to prove the position and successfully resolve the matters to the favor of the client.

Oftentimes, the most critical expert will be the business valuator because most shareholder/equity owner disputes center on issues of value. As was discussed earlier in these materials, valuation is fraught with complexity and conflict for a variety of reasons. There can be no replacement for having a quality business valuation expert in these cases.

A second expert that might be required is a forensic accountant, in the event that counsel suspects wrongdoing is reflected in the historical financial information. Investigating history within any format, and especially business dealings and operations, can be a cumbersome and detailed process requiring a substantial commitment of both money and time. There is, however, simply no means by which counsel can establish with any degree of veracity, the economic effect of prior improprieties without the aid of a forensic specialist.

It should go without saying that if a business valuator or forensic accountant might prove useful and necessary in establishing the position of the client, he or she should be engaged early in the process. Oftentimes, the same expert or advisor can fill both roles quite neatly if called upon to do so.

Another benefit of engaging outside experts early is the additional input and perspective that can be offered on the merits of the case. While all litigation support engagements are guided by legal counsel based on legal principles, economic advisors such as business valuators and forensic accountants can assist legal counsel in determining the cost/benefit of moving forward. This analysis obviously differs from the legal assessment. Even if the case is won, and the strategies developed early on are sound, the economic outcome may not be sufficient to reward the client for a multi-year campaign which must be funded both monetarily and emotion-

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ally. Both legal counsel and economic advisors must be careful not to cross that line where a successful result does not justify the effort on everyone's part.

An important consideration in moving forward may include a major shift in direction from the client. In these cases, the client may suddenly modify his/her expectations and needs without warning. Life events, such as the death of a spouse or loved one, a sudden illness or some other catastrophic event (within the client's world) might be the catalyst that drives the decision to pursue resolution through an alternative strategy and tactic. The authors have observed circumstances where a shift in the thought process of the client resulted in a re-engineering of the entire resolution strategy.

The road to resolution in these maters is one filled with obstacles. Emotions; personalities; bad feelings on everyone's part; poorly-crafted or outdated governing documents; a lack of open accessibility to financial and operating records; complex financial matters and, perhaps, even more-complex legal matters, combine to make work in this area exceedingly challenging. However, nothing can be more gratifying, from a professional standpoint, than to attain and fair resolution on behalf of any client under such difficult circumstances.

As is often said, …if it were easy, everyone would be doing it!

The authors, as well as all of the Partners and professionals at Grossman Yanak & Ford LLP, thank you for spending part of your busy day with us this morning. As always, we realize that the topics are quite complex, and that little information can be conveyed that will not require additional follow-up, research and study on the part of the participants. We do hope, however, that today's presentation has provided some thought-provoking information that may be of use to you and your firm as you return to your offices and practices.

Should you wish to ask a follow-up question, both Bob Grossman and Melissa Bizyak will be available for a short time after today's presentation has concluded. If you do not have time for that question today, please feel free to call Bob or Melissa at your convenience. We do not promise that we can answer every question immediately, but we do promise that if we cannot, we will research the matter and get back to you as soon as possible. The author's contact information is as follows:

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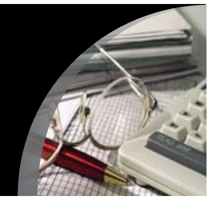
Thank you again and have a great day!



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