Valuation Principles in the Context of a Shareholder Dispute

Patricia M. Harris, CPA, CA • IFA, CBV, DIFA, CFF
Partner, Fuller Landau LLP

CHARTERED
BUSINESS
VALUATORS™

cicbv.ca

TABLE OF CONTENTS

Introduction	1
Value Definition	1
Minority Discount	3
Valuation Date	6
Type of Valuation Report	7
Calculation Valuation Report	7
Estimate Valuation Report	7
Comprehensive Valuation Report	7
Approach and Valuation Methodology	8
Normalization Adjustments	9
Fiscal year weighting	10
Capitalization Multiple	10
Shareholders Agreements: Impact on value	10
Expert Interaction: Reliance on other Experts and Pre-trial Valuation Expert hot-tubbing	12
Mandate: Definition and Agreement	13
Conclusion	13

This paper is not intended to be legal or other advice. The information provided is for discussion purposes only and reliance on the contents for any other purpose is strictly prohibited. The author of this paper, Fuller Landau Valuations Inc. and The Canadian Insitute of Chartered Accountants are not responsible for losses or other adverse consequences to any party arising from the contents of this paper.

© 2016 The Canadian Institute of Chartered Business Valuators

INTRODUCTION

The Canadian Institute of Chartered Business Valuators (CICBV) is nationally and internationally recognized as the preeminent business valuation organization in Canada. The CICBV establishes the practice standards, educational requirements, and ethical guidelines which govern the valuation profession.

With the CICBV's rigorous education requirements, practice standards and ethical guidelines for Chartered Business Valuators (CBVs) in place, it may appear inconsistent when two financial experts have differing opinions as to value. However, disparities in CBVs' opinions result from differences in assumptions, methodology, industry analysis, the use of public market benchmarks, mandate and professional judgment. In summary, differences often stem from the CBV's assessment of the amount and the risk in realizing the business' prospective cash flows.

In this paper, I review key issues that valuators typically assess when preparing a business valuation in the context of a shareholder dispute. Included is an examination of the following valuation concepts and issues with reference to some recent case decisions:

1. Value Definition: Definitions, Explanations and Comments
2. Minority Discount: Applicability and Quantum
3. Valuation Date: Complexities and Guidance
4. Type of Valuation Report: Calculation, Estimate or Comprehensive
5. Approach and Valuation Methodology
6. Shareholder Agreements: Impact on value
7. Expert Interaction: Appraisers and Pre-trial valuation expert "hot-tubbing"
8. Mandate: Definition and Agreement

VALUE DEFINITION

The definition of value is the foundation upon which a valuator's conclusion is based. Different definitions of value may result in different value conclusions.

Most valuation engagements, regardless of the ultimate value definition utilized, are premised on determining the **Going Concern Value of the Business**—the value of a business enterprise that is expected to continue to operate into the future.[1] This is the **Enterprise Value** of the business which includes both interest bearing debt and equity components (i.e., the value of the business in its entirety—including both the debt holders' and equity holders' interests).

The **Equity Value** of the business represents the value of a business to its shareholders (i.e., the enterprise value less interest bearing debt).[2]

Fair Market Value is the highest price expressed in terms of cash, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting

1 CICBV Practice Bulletin No. 2, International Glossary of Business Valuation Terms (developed by American Institute of Certified Public Accountants, American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts and the Institute of business Appraisers).

2 The definitions provided are for explanatory purposes in the context of this paper and are not to be considered an analysis of all of the component inputs of a valuation exercise.

 © 2016 The Canadian Institute of Chartered Business Valuators

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.

Practically speaking (and simplified), the valuator first determines the Enterprise Value of a business, then deducts the interest bearing debt and equivalents to isolate the Equity Value of the business with reference to a Fair Market Value definition.

Fair Value, although not defined in the International Glossary of Business Valuation Terms, is an important value in the context of a shareholder dispute and is generally considered to be the shareholder's pro-rata share of the Fair Market Value of a business (i.e., without reduction for a minority discount).[3]

In a recent case relevant to valuators practicing in the area of shareholder disputes, *Margarita Castillo* v. *Xela Enterprises Ltd. et al*, 2015 ONSC 6671 (*CanLII*), *Margarita Castillo*, the Applicant, brought an oppression application moving for an order requiring that her minority interest be purchased by the respondents (her father, brother and related entity). Two experienced Chartered Business Valuators provided "quite different" fair market value opinions to the Court.[4]

Interestingly, if we refer back to the Fair Market Value definition, the components of the Fair Market Value definition often clearly do not apply to the facts of the case. In many shareholder disputes, particularly where a majority will purchase a minority shareholder's interest:

1. The buyer and seller are often specifically identified;
2. The proposed transaction may not be at arm's-length;
3. The market is not open; rather, it is restricted to a buy-out between shareholders;
4. There is a compulsion to buy or sell. Working together may no longer be tenable and one or more shareholders may be compelled to sell his/her interest;
5. There is often an imbalance of power with respect to financing and the parties' knowledge of the business' prospects; and
6. There may be contractual agreements that prescribe value.

In *Margarita Castillo* v. *Xela Enterprises Ltd.*, supra, for example, there was a previous share sale transaction between Margarita's brothers and a holding company (*Xela*) pertaining to the shares of the company at issue. One of the valuators identified the transaction, but did not rely on it for the purposes of his Fair Market Value analysis on the basis that it involved non-arm's length parties (which does not meet the Fair Market Value definition).

At paragraph 72 of *Margarita Castillo* v. *Xela*, the Honourable Justice Newbould states *"Fair value is not the same as fair market value, but rather is a value based on principles of equity."* Further, at paragraph 78 of the decision, his Honour observes that although the previous share sale transaction between the brothers and Xela may not meet the definition of a fair market value analysis, it does not prevent the use of this amount from being considered *"…in what is a fair and just amount to be paid to Margarita…"*

Chartered Business Valuators must consider the facts of the case, precedent case law, valuation theory and practice standards all under the overriding principle that our duty is to provide the Court

3 A minority discount is the reduction from the pro rata portion of a minority shareholding to reflect lack of operational and strategic control, inherent lack of liquidity, etc. Also of note, is that in relatively rare circumstances, premiums have been added and included in the value of a minorities' pro-rata shareholding.

4 The Applicants expert valued the minority shareholders' shares as between $5.2 and $5.6 million, whereas the Respondent's expert valued her shares as either $900,000 or $2.6 million (depending on the applicability of a particular adjustment).

 © 2016 The Canadian Institute of Chartered Business Valuators

with a relevant, independent and objective opinion of value. Certainly, the determination of what is “fair” or “just” or even “relevant” is not the role of the valuator; it is the role of the Court. It is also the Court that will ultimately determine value (based, in part, on the expert opinion of valuators).

In *Smiechowski* v. *Preece*, 2014 ABQB 272 (*CanLII*), paragraphs 71 and 73, the Honourable Justice S.L. Hunt McDonald states that “There is very little statutory guidance on the meaning of *“fair market value” and “Fair market value is a value to be determined by the court on a case-by-case basis, as there is no single method of calculation.”*

As financial experts, however, it is not sufficient to simply provide a “laundry list” of what might be relevant for the Court to determine fair value. As valuation professionals in the context of a shareholder dispute, it is essential that we not only set out the relevant financial considerations in our reports, but we must also reference how those financial considerations may impact value. A valuator uses professional judgment to consider information that may be relevant in value determination, even if the information may not be consistent with a Fair Market Value definition.

The *Margarita Castillo* v. *Xela* decision notes other cases that are a good reference point for valuators with respect to the issue of value including *Glass* v. *618717*, 2012 ONSC 535 (*CanLII*), *R.* v. *Towne Cinema*, 1985 *CanLII* 75 (SCC), [1985] 1 S.C.R. 494, *Connor* v. *The Queen*, [1979] C.T.C. 365, 79 D.T.C. 5256 (F.C.A.), *Muscillo* v. *Bulk Transfer Systems Inc.* 2010 ONSC 490 (*CanLII*), and *Brant Investments Ltd. et al.* v. *KeepRite Inc. et al.* (1987), 1987 *CanLII* 4366 (ON SC), 60 O.R. (2d) 737; aff’d (1991), 1991 *CanLII* 2705 (ON CA), 3 O.R. (3d) 289 (C.A.). In addition, valuators must be aware of the “one true rule”[5] as set out in *Cyprus Anvil Mining Corp.* v. *Dickson*, 1986 *CanLII* 811 (BC CA), paragraph 51.

MINORITY DISCOUNT

There is a significant amount of literature related to the discussion of minority discounts. As a brief overview, a minority discount represents an amount or percentage deducted from the pro rata share of value of 100% of an equity interest in a business to reflect the absence of some or all of the powers of control.[6] The discount reflects the following disadvantages of owning a minority shareholding and the absence of the control, including lack of control over the following:

1. Business decisions;
2. The election of the majority of the Board of Directors;
3. Dividend policy;
4. Remuneration policy; and
5. Decisions concerning tax planning (i.e. bonuses, etc.).

All of the above, from a valuator’s perspective, can have an impact on assessing Fair Market Value (i.e., the “highest price available” for a minority shareholder’s interest). The discount reflects the

5 *Cyprus* v. *Dickson*, paragraph 51, *“The one true rule is to consider all the evidence that might be helpful, and to consider the particular factors in the particular case, and to exercise the best judgment that can be brought to bear on all the evidence and all the factors. I emphasize: it is a question of judgment. No apology need be offered for that. Parliament has decreed that fair value be determined by the courts and not by a formula that can be stated in the legislation.”*

6 See CICBV Practice Bulletin No. 2, International Glossary of Business Valuation Terms (minority discount and discount for lack of control).

 © 2016 The Canadian Institute of Chartered Business Valuators

limited external demand for a minority shareholding having regard to the above disadvantages balanced with reference to statutory minority shareholder rights.[7]

The quantum of a minority discount (if any) may be influenced by:

1. The applicable statutory rights and extent of the holding;
2. The degree of motivation of the purchaser and seller to transact (if a seller is motivated to sell, the discount may be higher and if the purchaser is motivated to buy, the discount may be lower, all else being equal);
3. The relationship between the shareholders (an ongoing relationship may reduce the discount);
4. The shareholder's involvement in the business (the greater the minority shareholders involvement, the lower the discount); and
5. The dividend yield on the shares (the greater the dividends with a payment history, the lower the discount).

As stated earlier, in the case of an open market price, a discount may only be established through negotiation. The range of minority discount that may actually be negotiated is so broad as to not be meaningful (0% to 75%, for example); however, we typically observe the application of minority discounts, applied in a notional context, in the range of 10% to 40%.

As noted earlier, if a minority shareholder is oppressed, a minority discount will almost certainly not be applied by the Court. However, the issues of oppression and value are often not bifurcated, but tried together. As such, valuations often consider the issue of minority discount when preparing a valuation in the context of litigation.

In *Margarita Castillo* v. *Xela*, for example, counsel for the respondents contended that a minority discount should be applied to Margarita's minority shareholding. However, because Justice Newbould found that the actions of the respondents were oppressive, no minority discount was applied, for reasons noted in paragraph 104, as follows:

Normally in a family situation in which one side is required to buy out the other at fair value, no minority discount is ordered, and

Xela had previously purchased the shares of the brothers without the application of minority discount.

The decision in *Pilch* v. *TemboSocial Inc.*, 2014 ONSC 5590 (*CanLII*) is an important read for valuators practicing in the area of shareholder dispute valuations. In that case, Lawrence Pilch and Rhonda Feldman collectively owned a 25% shareholding in TemboSocial. Lawrence Pilch was an employee. He was dismissed and sought relief under the Canada *Business Corporations Act*. The parties negotiated a consent order requiring (among other things) that the Respondents must purchase Pilch's shares at "the value" determined by the Court. There was an agreement between the parties that the issue of the application of minority discount was to be argued at trial.

Again, two experienced Chartered Business Valuators opined on value in *Pilch* v. *TemboSocial*, both utilizing the Fair Market Value definition of Value. The expert for the applicant was instructed not to consider the issue of minority discount, whereas the expert for the respondent determined that a minority discount would be in the range of 20% to 30%, if applicable.

7 This paper does not, nor is it intended to, add to the volume of discussion of the nuances, differentiation and interrelationship of minority discounts and marketability discounts but is intended only to provide background. Also of note is the concept of "Nuisance value" which relates to the incremental price that a controlling purchaser may pay to buy-out a minority shareholder. Typically, nuisance value is paid if a minority shareholder is blocking a sale of the business or if there are conflicts in personalities.

 © 2016 The Canadian Institute of Chartered Business Valuators

At paragraph 50 of the decision, the Honourable Justice Brown states *"A minority discount reduces the price attached to minority shares because they do not represent control of the corporation. Where, however, a court directs the compulsory purchase of shares by existing shareholders who thereby consolidate their existing shareholdings - such as in dissent, appraisal, winding-up and compulsory purchases under the oppression remedy - the rationale for a minority discount does not apply."*

Although there was no judicial finding of oppression, his Honour found that, given that the respondents were ordered to purchase Pilch's shares, and subsequent to the purchase, the respondents would end up owning all the shares of TemboSocial, his Honour concluded in paragraph 54 that *"the two-step valuation approach set out in the Diligenti case*[8] *should apply and that no minority discount should be used to determine the value of the Pilch shares."*

As such, even though there was no judicial oppression found in *Pilch* v. *TemboSocial*, no minority discount was found to apply because the buyer was identified and the minority shares that were being purchased did not come burdened with lack of control issues (considering that the purchasers already had control of the company).

Based on a review of case law, it appears uncommon for the Court to apply a minority discount within the context of a shareholder dispute including family members or other closely-held scenarios, notwithstanding that in an open market, a minority discount would typically factor into negotiations (in an open and unrestricted market between arm's length parties). The basis for this appears to be that the purchaser and seller of the shares are known and the buyer is generally the majority controlling shareholder subsequent to the purchase who is simply supplementing or consolidating his equity position.

Notwithstanding the above, and with reference to the earlier discussion in this paper, the valuator may still set out the financial considerations that impact the application of a minority discount, unless instructed by counsel not to do so, if utilizing a Fair Market Value definition. Setting out the factors that may influence a minority discount may assist the Court in its ultimate determination of what is relevant, and what is fair value.

Consider this simple example: In 2012, a minority shareholder purchased a 25% interest in a business for $200,000. No formal valuation was undertaken as a pre-condition to the purchase. Assume that both parties believed that the business' Equity Value was $1,000,000. Further, assume that all of the conditions of Fair Market Value were present. The underlying purchase, although not explicitly discussed, reflected a 20% or $50,000 minority discount [$1,000,000 x 25% = $250,000 x (1—80%) = $50,000].

What if, in 2016 the minority shareholder claims oppression? Assume that the business' Equity Value continues to be $1,000,000 supported by a valuation report. Without a minority discount applied, the minority shareholder would receive a buyout of $250,000—what could be considered to be a windfall of $50,000.

It is possible that the application of a minority discount may be required in order to fairly reflect the value of a minority shareholder's interest. If the minority shareholder's interest was previously acquired with reference to a minority discount, a Court may find that it is likewise fair to reflect a minority discount to value the interest in a way consistent with that under which it was acquired. Fairness is ultimately the Court's determination.

---

8 In summary, in *Diligenti* v. *RWMD Operations Kelowna Ltd.*, 1977 *CanLII* 393 (BC SC)., it is noted that the first step is to value the shares under a Fair Market Value definition and the second step is to look at who the purchasers are and what price is fair in the circumstances.

 © 2016 The Canadian Institute of Chartered Business Valuators

VALUATION DATE

A Valuation Date is the specific point in time as of which the valuator's opinion of value applies.

Whereas Valuation is point in time specific, litigation is not. There may be a continuum of business, economic and industry changing circumstances. As such, the Fair Market Value of a business may vary greatly during the course of the dispute and litigation. Relevant valuation dates may include the date when a minority shareholder left employment of the business, the date an application or claim is filed, or the current date (which may approximate the trial date or when the actual buy-out is ordered to occur).

If the issue of the Valuation Date is not agreed among the parties prior to the preparation and exchange of expert reports, valuators may be engaged to prepare a report with valuation conclusions at two or more Valuation Dates. In any event, information related to the increase or decrease in value may be helpful for the Court in its determination of what is "fair" at the determined Valuation Date. Take, for example, a business that continues to flourish without one of the shareholders, or alternatively, the business deteriorates in value subsequent to the shareholder's departure. This information may be of assistance to the Court for not only for value determination, but for other legal issues before the Court as well.

In *Zhao* v. *Zhao*, 2016 ONSC 2469 (*CanLII*), if was held that the Valuation Date was the date that was the triggering event of the dispute (i.e., when one shareholder was told he was no longer required to be an employee of the business).

1043325 Ontario Ltd. v. *CSA Building Sciences Western Ltd.*, 2015 BCSC 1160, paragraph 15, the Honourable Justice J. Sigurdson decided, *"As to the appropriate date for valuation, Pitfield J. noted in* Discovery Enterprises Inc. *v.* Ebco Industries Ltd.*, 2002 BCSC 1236 at para. 228 that "It is settled law that unless the result is unfair in the circumstances, the appropriate date for the valuation of relief is the date of filing the petition seeking relief under [then s. 200] of the* Company Act.*"*

Justice Sigurdson further stated at paragraphs 24 and 25 that, *"Generally, I would think that the oppressive majority should be bound by the valuation as at the petition date where the appropriate remedy is a buyout and that any increase or decrease should generally not accrue to the petitioner. I think that is particularly so in this case. While the petitioner seeks to have prior excessive fees taken into consideration and shared, the respondents say that financial downturns should also be shared. Both arguments in this case suggest that the usual date at the time of the petition is the fair one."*

In *Smiechowski* v. *Preece*, 2014 ABQB 272 (*CanLII*)[9], the Honourable Madam Justice S.L. Hunt McDonald at paragraph 75 states, *"In deciding the fair market value of Advantage's shares, I accept the valuation date used by the parties of September 30, 2012, which was the end of the month in which Mr. Preece ceased to be an Advantage employee."*

In summary, the Valuation Date is a key component of a business valuator's mandate, as there may be significant variations in value. On one hand, if the Valuation Date is either determined by the Court or agreed to by the parties prior to the preparation of the expert report, litigation costs may be reduced; on the other hand, details surrounding the valuation date determination may ultimately assist the Court in the ultimate determination of what may be a fair buyout price.

9 The decision in *Smiechowski* v. *Preece* was overturned on appeal (as discussed further in this paper in the section regarding shareholder agreements).

 © 2016 The Canadian Institute of Chartered Business Valuators

TYPE OF VALUATION REPORT

Section 15 to the CICBV's *Practice Bulletin "Guidance on Types of Valuation Reports"*[10] sets out considerations that may be relevant in assessing the suitability of a particular type of valuation report. A brief description of the scopes of work is as follows:

Calculation Valuation Report

The required extent of review, analysis and corroboration of economic, industry and company-specific information and factors in respect of a Calculation Valuation Report may be very limited. The scope of work in these engagements requires the gathering of valuation research and the application of valuation techniques and methodologies based on information that may be very limited and that may not have been corroborated by the Valuator. Valuators in such circumstances may reasonably not be aware of information or factors that could affect the conclusions reached to an extent that may be significant. Calculation Valuation Reports provide the lowest level of assurance.

Estimate Valuation Report

In comparison to a Comprehensive Valuation Report, Estimate Valuation Reports may be based on a more limited review, analysis and corroboration of economic, industry and company-specific information and factors giving consideration to the purpose of the valuation engagement, taking into consideration the cost of expanding the extent of such review, analysis and corroboration in comparison to the added assurance that will be achieved and the need for such assurance. The scope of work undertaken to support the conclusions of Estimate Valuation Reports normally includes review and analysis of economic, industry and other factors that could significantly affect the conclusions reached.

Comprehensive Valuation Report

In completing a valuation analysis that is suitable for a Comprehensive Valuation Report, the Valuator must use reasonable efforts to obtain, review, analyze and consider all available information and factors that could have a significant effect on the conclusions reached. Further, this information should be corroborated using reasonable efforts to determine whether it can be relied upon for purposes of arriving at a valuation conclusion. Comprehensive Valuation Reports provide the highest level of assurance.

As set out above, the Comprehensive Valuation Report provides the highest level of assurance and generally would be the preference of Chartered Business Valuators testifying with respect to his or her report because more and deeper analysis would have been conducted. Practically speaking, costs or scope limitations may necessitate that an Estimate or Calculation Valuation Report be prepared.

The valuation profession is self-regulating and valuation conclusions are based on professional judgment. There is no formula or rule that dictates the level of report required, only guidance. The level of valuation report provided is a matter of the agreed upon mandate. Generally, in settlement discussions, an Estimate Valuation Report may be considered by counsel to be sufficient, often with the valuator's caveat that the report may be upgraded to a Comprehensive Report if the case proceeds to trial, if agreed upon and if the valuator is engaged to do so.

In *Pilch* v. *TemboSocial*, the experts prepared Comprehensive Valuation Reports. In *Magarita Castillo* v. *Xela*, and *Zhao* v. *Zhao*, the type of valuation report prepared was not identified.[11] In *Smiechowski*

10 CICBV website, cicbv.ca/practice-bulletins-2/.

11 There are numerous matrimonial case decisions that refer to the acceptance of a *Calculation Valuation Report* as expert evidence.

 © 2016 The Canadian Institute of Chartered Business Valuators

v. *Preece*, 2014 ABQB 272 (*CanLII*), a Calculation Valuation Report was considered by the Honourable Madam Justice S.L. Hunt McDonald; however, at paragraph 91, Justice Hunt McDonald states that she found the accountant's *"explanations and overview of Advantage's financial statements to be helpful. However, he is not an expert in business valuations, and accordingly, his evidence was of limited assistance in determining a fair market value for the shares of Advantage."*

Practically, counsel may not want to tender an Estimate Valuation Report if opposing counsel's expert has prepared a Comprehensive Valuation Report. However, as valuations (and the extent of work prepared for each level of report) is based on professional judgment, it is up to the Court to determine the extent to which the valuation report is relied upon, regardless of the level of report prescribed by the CICBV.

In a shareholder dispute valuation, the valuator is often hindered by not having direct and unencumbered access to all of the shareholders. It is up to the Chartered Business Valuator's professional judgment with reference to the CICBV Practice Standards to determine if sufficient investigation or research has been conducted in order to issue a Comprehensive Report under any scope limitations.

No matter which level of report is prepared, ultimately it comes down to the Court's assessment of the opinion provided. It is the Chartered Business Valuator's duty to the Court to fully set out the documents reviewed, the methodology implemented and any limitations related to his or her valuation conclusion in accordance with CICBV Practice Standards.[12]

APPROACH AND VALUATION METHODOLOGY

Within the context of a shareholders dispute, most approaches consider that the business is a going concern[13] as at the Valuation Date. Methodologies are categorized into income, market and asset approaches.[14]

An income methodology was utilized in each of *Pilch* v. *TemboSocial*, *Zhao* v. *Zhao*, *Smiechowski* v. *Preece*, *Sherk* v. *Sherk* 2015 CarswellOnt 20801, 2015 ONSC 7213 and *Margarita Castillo* v. *Xela*.

For the purposes of this paper, I will focus on the Capitalized Cash Flow methodology, wherein a multiple[15] is applied to maintainable ongoing cash flow or EBITDA[16] ("Maintainable Cash Flow"), to determine Enterprise Value. From Enterprise Value, debt is deducted and the value of redundant assets is added.

12 Refer to the CICBV website for practice standards and guidance.

13 A going concern is an ongoing operating business enterprise.

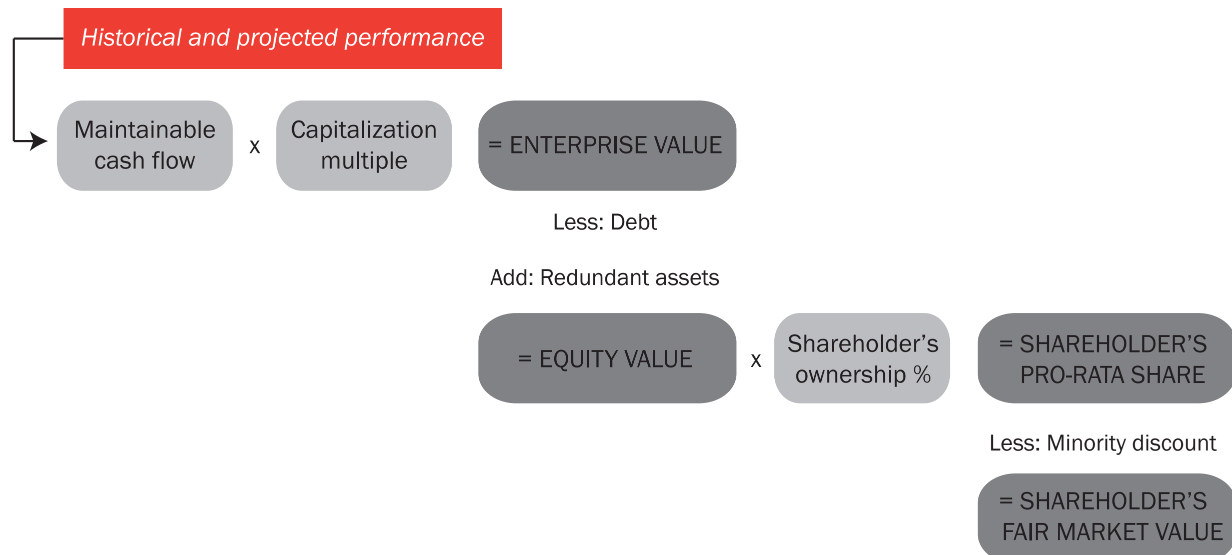
14 Income based methods estimate the future expected earnings/cash flows of a company either on a capitalized or discounted basis, while market based methods estimate fair market value by analyzing and applying market transactions to the company's actual transactions. Asset based methodologies use the current or adjusted book value of the company's net tangible assets in determination of value.

15 The multiple is the inverse of a capitalization rate, reflecting the risk faced by a company in earning the ongoing cash flows. The International Glossary of Business Valuation terms includes a definition of "Capitalization Factor — any multiple or divisor used to convert anticipated economic benefits of a single period into value."

16 EBITDA is earnings before interest, tax, depreciation and amortization.

 © 2016 The Canadian Institute of Chartered Business Valuators

A simple illustration of the mechanics of a Capitalized Cash Flow methodology[17] is as follows:



Differences in a valuator's conclusion may be caused by differences in, among other things:[18]

1. The *normalization adjustments* made to historical earnings;
2. The *fiscal year weighting* of the company's historical earnings performance; and
3. The *capitalization multiple* applied.

Normalization Adjustments

In *Pilch* v. *TemboSocial*, normalization adjustments differed between valuators. The valuator for the applicant contended that professional fees for recruiting costs in the fiscal year closest to the Valuation Date were non-recurring in nature (and thereby calculated a higher Maintainable Cash Flow based on lower annualized professional fees in consideration of those fees in earlier years).[19]

The valuation expert for the respondent estimated recruitment fees based on information provided by management estimates. In determining a level of professional fees, the Honourable Justice D. M. Brown at paragraph 21 states, *"…on this issue one is entering into the murky realm where valuation is more art than science."*

The estimate of Maintainable Cash Flow requires significant professional judgment, particularly because Maintainable Cash Flow represents, after a review of all of the items in the Valuator's scope of review, what the valuator considers to be a best estimate of what will happen subsequent to the Valuation Date, without the use of hindsight.

In *Pilch* v. *TemboSocial*, his Honour adjusted and thereby normalized the professional fees in an amount not specifically put forward by either expert, but by taking components of each which was an amount, that presumably, his Honour considered to be fair, using judgment and given the evidence before him.

17 For a detailed explanation of the Capitalized Cash Flow methodology, see Chapter 5 of Johnson, Howard E. *Business Valuation*. Toronto: *The Canadian Institute of Chartered Accountants*, 2012.

18 The extent of redundant assets included in Equity Value is also an area of differences, for example.

19 The implication is that less fees result in higher normalized earnings, and as such higher value.

 © 2016 The Canadian Institute of Chartered Business Valuators

Fiscal year weighting

The valuator generally will examine at least a few fiscal years prior to the Valuation Date in the determination of Maintainable Cash Flow, generally relying more heavily on recent historical performance and management forecasts (if available and reliable).

Assessment of historical financial data as a predictor of future performance (if appropriate in the circumstances), all else being equal, works best with more (vs. less) fiscal years assessed. The key with valuation analysis of prior fiscal years' data is to ensure relevance. Fiscal year weighting of historical Maintainable Cash Flow could be a range of one to five fiscal years, or more, in some circumstances.

The decision in *Pilch* v. *TemboSocial*, for example, weighted the most current two full fiscal years and a partial fiscal year up to the Valuation Date. The fiscal year weighting is also a matter of the valuator's professional judgment.

Capitalization Multiple

The lower the multiple, the higher the Valuator's assessment of the risk to the business in earning Maintainable Cash Flow. Certain components to the determination of the Capitalization Multiple utilized have generally acceptable benchmarks (for example, risk free rates, and equity risk premia). The determination of the Capitalization Multiple is of significant importance to the Valuation and is matter of the valuator's professional judgment.

In *Margarita Castillo* v. *Xela*, the applicant's valuator applied a Capitalization Multiple of 5 to 6 times Maintainable Cash flow, while the other valuator applied a Capitalization Multiple of 3.4 to 4.7 times. In paragraph 102 of the decision his Honour provides a calculation of value using the multiple of the respondent's valuator applied to the Maintainable Cash Flow as calculated by the applicant's valuator. There was reliance on both valuators for different components of the calculation. Ultimately, the value conclusion found by the Honourable Justice Newbould was within that range.

It is important to note that Chartered Business Valuators typically include a statement within the valuation report to the effect of *"The report must be considered in its entirety. The preparation of our report is a complete process and is not necessarily susceptible to partial analysis. Selecting only portions of our report or some of the factors, considered, without considering all components and factors together, could create an inaccurate view of our findings."*

In *Zhao* v. *Zhao*, the multiples used by the valuators differed significantly. As set out in paragraph 233 of the decision, differences in the calculation resulted from differences in *"(1) the size premium; (2) the company specific risk premium; (3) the debt to equity weighting; and (4) the growth factor."*

Recent cases illustrate that differences between valuators result generally not from the methodology implemented, but in the application of the methodology (the determination of Maintainable Cash Flow, the Capitalization Multiple and the Redundant Assets). As noted above the court has, in some recent cases, approached its ultimate valuation determination by utilizing components of the reports or evidence of both valuation experts.

SHAREHOLDERS AGREEMENTS: IMPACT ON VALUE

A shareholders' agreement is a contractual arrangement among shareholders setting out, among other things shareholder rights and obligations, methods for determining compensation, and dispute resolution. In addition, a shareholders agreement may set out a methodology for calculating the price at which the shares of a shareholder must be purchased under various conditions.

 © 2016 The Canadian Institute of Chartered Business Valuators

The *Sherk* v. *Sherk*, 2015 ONSC 7213 case details the adherence to process with respect to disagreements regarding the valuation of a shareholder's interest. In that case, two brothers each owned 50% of an insurance company. The shareholders' agreement included a provision that, in order to determine fair market value, either brother was entitled to obtain an opinion from a first appraiser. If there was a dispute with the value, the other brother was likewise entitled to obtain an opinion from a second appraiser. The shareholder agreement also provided that, *"In the event that opinion of the second appraiser differs by more than Ten Percent from the opinion of the first appraiser a third appraisal, from an appraiser selected by the first two appraisers, shall be obtained…"*

Each brother obtained a valuation report, one determining fair market value to be $6,100,000 (and $4,100,000 assuming an absence of a non-competition covenant) and the other report determining fair market value to be $9,630,000. A third valuator was jointly retained by the brothers, determining a range of values of approximately $7,291,000 to $8,030,500 based on varying assumptions with respect to a non-competition covenant and minority discount.

Ultimately, His Honour Justice Turnbull concluded at paragraph 33, *"In my view based on the reports before the court, the approximate value of Richard's shares at valuation day is $7,500,000."*

In *Smiechowski* v. *Preece*, 2014 ABQB 272, 2014 *CarswellAlta* 1145 (later appealed, as described below), there was a dispute over the wording of the shareholders' agreement and qualification of the author of the share valuation.

While the plaintiff and defendant each engaged an expert, the plaintiff also engaged a Chartered Accountant, a partner of the accounting firm that prepared the company's annual financial statements.

As noted in the decision, paragraphs 69-81, Schedule A of the shareholders' agreement *"…requires that any evaluation made by an accountant pursuant to this Schedule shall be based on the fair market value of each share being sold…"*

Further, Schedule A provided that, *"the purchase price shall be determined conclusively by the accountants of the Corporation applying generally accepted accounting principles."* Schedule A outlined the methodology under which the determination of fair market value of the shares was to be undertaken (paragraph 82 of the decision).

This case highlights the differences of Fair Market Value definition within a shareholders' agreement and that of the standard valuation practices as provided by qualified experts. In paragraph 135, the Honorable Madam Justice Hunt McDonald states *"I find that the USA [Unanimous Shareholders Agreement] requires any valuation to be for "fair market value." However, the valuation methodology set out in the USA does not follow standard business valuation practices and, in order to determine the fair market value of the shares of Advantage, it is necessary that I do not follow the requirements in Schedule A."*

Her Honour concludes that although the accountant follows the terms of the shareholders agreement, his value per share is not Fair Market Value. As such, Justice McDonald decides on value based on the approach and value determined by the plaintiff's expert.

The decision of the Honourable Madam Justice Hunt McDonald was successfully appealed in *Smiechowski* v. *Preece*, 2015 ABCA 105 (*CanLII*). More specifically, the appellate court held that while the accountant was not a qualified expert, he did in fact follow the provisions set in in the shareholders' agreement regarding the formula for Fair Market Value. Further, there were no specifications regarding the specialized qualifications of the author of the report on valuations.

 © 2016 The Canadian Institute of Chartered Business Valuators

As the appellate court sets out in the decision at paragraphs 6 to 8, *"The trial judge declined to accept Mr. Creelman's valuation because he was not a Chartered Business Valuator. The parties could have specified that the value was to be set by an independent Chartered Business Valuator. They could have specified that the value set by the corporation's accountant was not conclusive, and could be challenged. They could have specified that certain minimum valuation standards would be met, beyond those in item 6 of Schedule "A". The contract is, however, clear. Provisions of this sort are designed to provide certainty to the parties, and avoid the very kind of litigation that has resulted here...While the trial judge preferred the opinions of the expert witnesses, the discretion over choosing which multiplier to use, and which income figures to take off the company's statements (as prepared in accordance with GAAP) was with Mr. Creelman. Since no one suggests that his valuation was prepared in bad faith, there was no basis for the trial judge to substitute the opinions of the expert witnesses."*

The Court maintains jurisdiction and discretion as to whether any specific provisions of a shareholders' agreement is enforceable. It is the valuators responsibility to review shareholder agreements that are relevant to the valuation exercise. Even though the mandate may be to determine value under a different value term, it may be helpful to the Court to understand and consider the terms related to valuation within the shareholder agreement.

In addition, it is incumbent upon the valuator to ask for details of any transactions for the entity's shares within proximity to the Valuation Date (based upon professional judgment), including transactions between shareholders.

EXPERT INTERACTION: RELIANCE ON OTHER EXPERTS AND PRE-TRIAL VALUATION EXPERT HOT-TUBBING

A Chartered Business Valuator may encounter, rely upon and provide comments regarding the work of other experts in the context of his or her engagement related to a shareholder dispute.

The CICBV Standard No. 120, *Scope of Work Standards and Recommendations* states, *"The Valuator shall consider the necessity of relying upon the work of a specialist, for example, real estate appraisers, engineers, or equipment appraisers."*[20]

If the findings of appraisers or other experts that form underlying components of the share valuation are agreed to prior to the preparation of the valuation report, matters may be simplified.

Pre-trial "hot-tubbing" occurs when experts meet prior to trial to potentially resolve differences or set out the differences and the reasons for those differences. This meeting may facilitate settlement or assist the Court at trial.[21]

In *Bimman* v. *Neiman*, 2015 ONSC 2313 (*CanLII*), the valuators each relied on separate real estate appraisers and actuaries. There were three levels of "hot-tubbing"—the appraisers, the actuaries and the valuators of both parties met prior to the trial.

At paragraph 163, the Honourable Justice Gans states, *"At my suggestion, the three sets of experts, namely the Actuaries, Real Estate Appraisers and Business Valuators, met or spoke to discuss their*

20 CICBV Standard 120 also provides a *"(Recommendation: if it is deemed appropriate to request the assistance of a specialist, the Valuator should obtain reasonable assurance concerning the specialist's reputation for competence and degree of independence.) (Explanatory comment: the appropriateness and reasonableness of the assumptions and methods used by the specialist are the responsibility of the specialist..."*

21 Under the Ontario Rules of Civil Procedure, 20.05 (2) (k), the Court may give direction or stipulate that experts meet on a without prejudice basis before trial.

 © 2016 The Canadian Institute of Chartered Business Valuators

respective reports, without counsel, in an effort to determine whether there was any congruence of opinion and to what level their points of divergence could be clarified. Mercifully, the actuarial conclusions were agreed to. This left me ultimately to decide a question of law, one which I have deferred to the back end of these reasons."

In *Karrys* v. *Karrys*, 2014 ONSC 713 (*CanLII*), at paragraph 19, the Honourable Justice D.M. Brown noted that there were material differences between the experts, and ordered the experts, *"...to meet, in the absence of counsel, and to prepare a joint statement, signed by both of them, which clearly:*

(i) identifies their areas of agreement;

(ii) identifies their areas of disagreement; and,

(iii) explains in detail the reasons for any disagreements in their opinions."

In *Glass* v. *618717 Ontario Inc.*, 2012 ONSC 535 (*CanLII*), the valuators prepared a joint statement *"identifying areas of disagreement and the financial implications of those disagreements."*

Whether ordered by the Court or undertaken voluntarily by the parties, pre-trial "hot-tubbing" of valuators appears to be a sound course of action. If experts can at least clearly set out their differences and the reasons for those differences, this process should increase efficiency in the litigation process and otherwise assist the Court.

MANDATE: DEFINITION AND AGREEMENT

An important component of any valuation engagement is the definition of the mandate. With respect to a shareholder dispute valuation, details will generally include the shares to be valued, the valuation date(s), the share percentage to be valued, the specific definition of value (possibly with reference to the shareholders agreement), and if a minority discount will be considered.

It is a matter for the Chartered Business Valuator to determine the necessity of an engagement letter. However, setting out a detailed mandate in a shareholder dispute valuation is important, particularly in a joint or court appointed retainer, so as to create a uniform understanding of the engagement.

CONCLUSION

The basis of the preparation of a valuation in the context of a shareholder dispute is a complex area of practice. Our work is "more art than science" on multiple levels. First, the valuator works within the guidance and standards of the CICBV, applying definitions of value that may have hypothetical conditions which are inapplicable to the case facts. Second, we must balance providing all of the relevant information to the Court, deciphering the information, applying expertise and providing an opinion on value, with the view to assisting the Court in its determination of fair value.

No doubt, Chartered Business Valuators working in the area of shareholder dispute valuations must appreciate that, despite being paid by a litigant, first and foremost our duty is to the Court to provide evidence that is fair, objective and non-partisan.

 © 2016 The Canadian Institute of Chartered Business Valuators