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Aligning Shareholder Interests to Mitigate Predictable Conflicts

Direction of company and liquidity timing are the most common shareholder conflicts.

by Mike Dannenberg

Shareholder conflicts generally arise because the interests of shareholders do not align. Each investor in a company has his or her own time horizon, risk tolerance, and liquidity needs, which generally change with the age and personal circumstances of the individual. When these requirements conflict with what is best for the business, it is usually the business that suffers.

The purpose of a shareholder agreement is to provide a mechanism to solve the inevitable conflicts that will arise between shareholders as a result of these circumstances. Generally, these conflicts fall within two camps: the direction of the company and the timing for liquidity. The first relates to the shareholders' ability to influence the strategic direction, operating decisions, investments, personnel, and customer/supplier relationships so as to maximize value creation. Although owners might not always agree, most agreements address potential conflicts by clearly articulating rules for voting, board appointments, and the roles of company officers. Nevertheless, lack of common agreement on the direction of the company can lead to the second area of conflict, which is getting cash to shareholders, either through distributions or sale of interests. Rarely, in our experience, do shareholder agreements adequately deal with timing differences among owners with regard to their needs for liquidity.

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TODAY VS. TOMORROW

One theme we repeatedly see is the conflict between shareholders who wish to invest in the future growth of the business and those who prefer current income and/or near term liquidity.

Many shareholders in privately held businesses are accustomed to taking annual distributions, viewing these cash flows as a critical source of income upon which they have become reliant upon and are unwilling to suspend or risk it on a business transformation. This is a perfectly understandable point of view – especially if current income has been received for an extended period of time. However, in a dynamic business environment, no industry is immune from disruption, and businesses that don't continually invest will ultimately see their profits competed away. Ironically, the shareholder focused on current income is often making the riskiest choice, gambling that none of their competitors will innovate.

THE CONUNDRUM

Unlike public securities where a liquid market exists, in privately held businesses, owners' desires to sell their stakes have important ramifications for all shareholders. For minority shareholders desiring liquidity prior to that preferred by their partners, few avenues exist to achieve their objective. Forcing the company or their partners to buy them out through the use of a "put" can create uneven risk between the selling and buying shareholders. Forcing the sale of the business or the acceptance of a new partner can also represent problems for the remaining shareholders.

The challenge is how to accommodate the desire for liquidity of a minority partner without disadvantaging the remaining investors. This is a difficult balancing act and will result in different conclusions based on the macro environment, the life cycle of the business, and the individual circumstances of each shareholder.

AN EQUITABLE SOLUTION

The best effort we've seen attempting to accomplish this emphasizes the protection of the remaining shareholders, while providing a mechanism to pursue liquidity for the selling minority shareholder.

1. After a specified period of time, the shareholder desiring liquidity notifies the company that they wish to sell shares at a specific price;

2. The company has the first right to repurchase the shares;

3. If the company is not interested, all non-selling shareholders have the right to buy the shares proportional to their ownership;

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4. If no transaction occurs, the selling shareholder can provide the board a list of potential non-shareholder parties for consideration;

5. Parties can be rejected for a variety of reasons, including being a competitor, having a criminal record, or being viewed as having insufficient capability to make the investment;

6. Management will cooperate with the selling shareholder to contact approved investors by providing a comprehensive description of the business under the protection of a non-disclosure agreement and answering questions to enable the potential investor to make a knowledgeable decision;

7. If any of the parties agree to a purchase at or above the seller's terms, the sale will be allowed and the party admitted into the existing

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shareholder agreement; and

8. If a party agrees to a purchase at a price lower than the seller has proposed, the offer must again be offered to the company and the other shareholders at the lower price.

This mechanism has the advantage of aligning the company and all of its shareholders by providing liquidity for minority without subjecting the company to any risk of proprietary information disclosure.

ALIGN CAPITAL SOURCES WITH RISK PROFILES AND TIME HORIZONS

Aligning the goals of shareholders with differing time horizons and appetites for risk is extremely difficult and, in many cases, impossible. Even if there was a shared vision at one point, over time, circumstances change and generational transfers increase complexity. These situations are inevitable and almost always predictable.

Partners in private illiquid investments who do not share a common vision or objectives present a problem for everyone. The best one can do is to try and keep all shareholders aligned by providing them a logical business plan and rationale for why this direction of the company is in the best interests of each shareholder. As the time horizon lengthens, it is more likely that divergence of objectives will occur and it is in everyone's best interest to try and accommodate a solution. Often the only way to overcome these hurdles is to replace the current shareholders with alternative sources of capital whose timing and risk appetite more closely align with the requirements of the company and the other shareholders. This can allow the business to be adequately capitalized to execute on growth plans while allowing departing shareholders to invest in assets more suitable to their individual circumstances. **ZS**

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

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