

Valuations for Dissenting Stockholder & Minority Oppression Actions

January 5, 2012

DISCLAIMER

The views expressed by the presenters do not necessarily represent the views, positions, or opinions of the AICPA or the presenter's respective organization.

These materials, and the oral presentation accompanying them, are for educational purposes only and do not constitute accounting or legal advice or create an accountant-client or attorney-client relationship.

Panelists



Neil J. Beaton, CPA/ABV/CFF, CFA, ASA

Grant Thornton LLP

Neil.Beaton@us.gt.com

(206) 398-2487



Alex W. Howard, CFA, ASA

HFBE, Inc.

Alexh@hfbe.com

(713) 225-9580

Outline of Today's Presentation

- **Brief History of Dissenter Actions**
- **Standard of Value: Fair Value**
- **Premise of Value: Going Concern**
- **Fairness**
- **Brief History of Shareholder Oppression Actions**
- **Selected Cases**
- **Observations and the Appraiser's Burden**

Dissent Defined:

“A withholding of assent or approval.”

Black’s Law Dictionary, Third Pocket Edition, 2006

- Occurs in the context of a transaction, such as a merger, which may be economically detrimental to the minority shareholder or member
- Non-voting stock may not be allowed to dissent

Brief History of Dissenter Actions

- Early corporations required unanimous consent, creating “nuisance” minority shareholders
- Majority rule eventually replaced unanimous consent, with potential for abuse (Wheeler v. Pullman Iron and Steel Co., 1892)
- Dissenter’s rights or “appraisal rights” gave minority the ability to “opt out” of transactions that could be economically detrimental to the minority
 - in return, they received the fair value of their shares
- Unlike oppression, liability does not have to be shown or proven
- To perfect their appraisal rights, minority S/Hs give notice before shareholder vote and relinquish all rights except fair value, defined by statute

Dissent Triggers

- Merger
- Share exchange
- Disposition of Assets
- Amendment to Articles of Incorporation
- Any other amendment to the articles from which shareholders may dissent
- Domestication from a foreign entity to a domestic entity
- Conversion of status to nonprofit
- Conversion to an unincorporated entity

Source: BVR's 2010 Guide to Fair Value in Shareholder Dissent, Oppression and Marital Dissolution

Standard of Value: Fair Value

- **Revised Model Business Corporate Act 3rd Ed. (1984):**

The value of the shares immediately before the effectuation of the corporate action to which the shareholder objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.

- **Revised Model Business Corporate Act 4th Ed. (2008):**

The value of the shares immediately before the effectuation of the corporate action to which the shareholder 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(a)(5).

Standard of Value: Fair Value, cont.

■ 33 States rely on the RMBCA for to define fair value

- 23 rely on the 1984 RMBCA
- 10 use the 2008 version

■ Evolution of RMBCA

- 1984 definition as part of remedy for shareholders seeking liquidity
- 2008 definition as part of remedy to resolve conflicts of interest

Standard of Value: Fair Value, cont.

- American Law Institute definition (6 states: CO, MN, NJ, AZ, CN, UT):

...the value of the eligible holder's proportionate interest in the corporation, without any discount for minority status or, absent extraordinary circumstances, lack of marketability. Fair value should be determined using the customary valuation concepts and techniques generally employed in the relevant securities and financial markets for similar businesses in the context of the transaction giving rise to appraisal.

- Other states have developed their own definitions of fair value or have used different standards of value (e.g., OH, LA “fair cash value”)

Standard of Value: Fair Value, cont.

- **RMBCA and ALI have informed state statutes, which have since been interpreted by the courts**
- **Stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern (Tri-Continental Corp. v. Battye, 1950)**

Premise of Value: Going Concern

- **Appraisal rights effectively afford controlling shareholder(s) ability to continue operations**
- **California is the exception for oppression suits**
 - Value as a forced liquidation, OR
 - Value as a going concern, but under compulsion to sell

Fairness

■ Delaware standard: Entire fairness

- Procedural fairness or fair dealing (Kahn v. Lynch Co, Del. Supr., 669 A.2d 79, 84 (1995))
 - Board's composition and independence
 - Timing, structure and negotiation of the transaction
 - How board and shareholder approval were obtained
 - Extent to which board and shareholders were accurately informed
- Fair consideration (substantive fairness)

■ Fair Consideration

- Absolute fairness: consideration received adequate relative to value of consideration surrendered
- Relative fairness: consideration received fair in comparison to what other shareholders received

■ Other jurisdictions: Arm's Length Bargain

Dissent Valuation Guidance

- Dissenters neither harmed or advantaged by the proposed action
- Allow for “normal” merger synergies
- Valuation date considers events that are known or knowable
- Company-level discounts may be allowed
 - Closed-end investment company
 - Trapped-in capital gains
 - Contingent liabilities

Dissent Valuation Guidance, cont.

- Since control discounts disallowed, guideline company approach must add control premium
- DCF may result in control – be careful here
- Court need not give any weight to terms of merger or prior offers in valuing the shares of a dissenting shareholder (M.P.M. Enterprises v. Gilbert, 731 A2d 790 (Del 1999))

Oppression Defined:

“Unfair treatment of minority shareholders (esp. in a close corporation) by the directors or those in control of the corporation.”

Black’s Law Dictionary, Third Pocket Edition, 2006

- Requires proving liability
- More egregious and “personal” than dissension
- Damages can be different than fair value
- May not assume going concern premise (California - “fair value in liquidation”)

Oppression is One Grounds for Corporate Dissolution Under RMBCA

- Directors are deadlocked
- Directors or those in control have acted, are acting or will act in a manner that is illegal, *oppressive*, or fraudulent
- Corporate assets are being misapplied or wasted
- Shareholders are deadlocked
- Courts will account for the oppressive, fraudulent or illegal acts in calculating for the fair value of the oppressed shareholder's interest (i.e., "equitable adjustments")
- Most states require minimum percentage ownership (20%+) to force dissolution

Brief History of Oppression Actions

- Under majority shareholder rule, remedy in most states was corporate dissolution
- Such a drastic remedy required egregious conduct: waste of corporate assets, gross fraud, or illegality
- States instituted buy-out provisions (CA 1941)
- RMBCA introduced statutory fair value buy-out for shareholders filing for dissolution (1991), allowing business to continue
- Note: DE does not cite shareholder oppression in its dissolution statute
- Note: CA remedy is fair value in liquidation

Source: BVR's 2010 Guide to Fair Value in Shareholder Dissent, Oppression and Marital Dissolution

Oppression Triggers (Evidence of Oppression)

- **Breach of fiduciary duty**
- **Unfair or unreasonably burdensome conduct by the majority**
- **Breach of the minority shareholder’s “reasonable expectations”**
 - Return on investment
 - Dividends
 - Employment

Oppression Valuation Guidance

- Valuation date may be based on date actual oppression began vs. the date of the action
- Review shareholder agreements to understand if they have been revised in favor of the majority
- Understand components of and history of shareholder compensation
- Review provenance of the subject shares

Cases – Disclaimer

The commentary on these cases is derived principally from the presenters' own viewpoints and does not necessarily reflect the views or opinions of the courts or their respective employers.

Sunbelt Beverage, DE Chan 2010 (Dissent)

■ Facts

- *Shareholder agreement was three years old*
- *Formula relied on book value, ignored intangible value*
- *Agreement required put or call, but was not properly executed*
- *When applied to guideline public companies, formula drastically understated the market capitalization*
- *Defendant's expert added company-specific risk premium to account for risky management projections*
- *Company planned to convert to S-Corp status post-merger*

■ Chancery Court ruled

- No weight attached to the shareholder agreement formula in determining fair value
- Company specific risk premium disallowed, as management projections are always inherently risky and Sunbelt's were not unusually risky
- Shares valued as C-corp shares, the shares given up

Julian v. Julian, DE Chan 2010 (Dissent)

■ Facts

- *ESDC held real estate directly, indirectly and subject to options*
- *Stockholder agreement governed valuation of the stock at adj. NBV of the real estate held by ESDC, net of sales expenses*

■ Court ruled

- Drafting history and performance were consistent with real estate owned through JVs to be included in “real estate held”
- Options represent executory contract and were not considered “real estate held”
- Customary sales expenses could be deducted
- Discount for partial interests of real property was not allowed
- Real estate appraisals prepared by third party MAIs were accepted, since no fraud, bad faith, partiality or deception was shown

Gesoff v. IIC, DE Chan 2006 (Dissent)

■ Facts

- *CP decided to take its 80% owned subsidiary IIC private*
- *Sole independent director's role was circumscribed, attorney and IB recommended had already worked for or with CP*
- *Defendants claimed that process was fair or at least harmless flawed and that the price determined pre-9/11 was more than fair post 9/11*
- *Both experts adjusted management's financial forecasts*

■ Court ruled

- The merger process was marked with grave examples of unfairness
- Defendants failed to show that 9/11 significantly affected the Company
- Petitioner's expert report was disregarded due to errors and misapplication of control premium to DCF analysis
- Defendant's expert report was accepted with adjustments:
 - Specific company risk premium was disallowed
 - Small company risk premium for US companies was applied to international companies with adjustments

Global GT, DE Chan 2010 (Dissenter)

■ Facts

- *Vimpelcom acquired shares in Golden, owned by Global, who alleged the company was undervalued in the sale at \$105 per share*
- *Acquirer's stock price increased at acquisition vs. dropping*
- *Experts disagreed on terminal growth rates*
- *Neither expert was considered an industry expert by the Court*
- *(One) expert used forward looking beta to develop discount rate*
- *(One/Same) expert used historical equity risk premium*

■ Chancery Court ruled

- Terminal growth rate between growth rate in foreign (Russian) GDP and inflation was appropriate
- Equity risk premium of 6% based on historical beta of 7.1%, adjusted downwards for recent research, was “most responsible to “deploy”
- Barra forward looking beta based on “undisclosed recipe” was disallowed in favor of observable historical beta

Crescent v. Dr. Pepper, DE Chan 2008 (combined action)

■ Facts

- *Shareholders brought appraisal action and fiduciary action*
- *Single buyer for regional bottler was franchisor*
- *CEO projected 3% real growth, price increases of 0.4%*
- *Buyer projected 4% real growth, price increases of 1.8%*
- *Plaintiff dissenters asserted that CEO knowingly provided misleading information for fairness opinion*

■ Court ruled

- CEO prepared a truthful and reasonable estimate in good faith
- CEO did not participate in preparation of higher growth rate projections
- Even though merger consideration was less than the fair value determined by the Court, CEO fulfilled his fiduciary duty
- There was only one buyer and how often does the only buyer pay full price?

Montgomery Cellular v. Dobler, DE Sup 2005

■ Facts

- *Minority shareholders file appraisal action for inadequate offer price that was based on prices paid in similar buyouts*

■ Court ruled

- Respondent expert's DCF was meaningless
 - Growth rate was generic, based on GDP
 - Expert created projections
- Petitioner expert's DCF was adjusted
 - DCF control premium was removed
- "Settlement haircuts" observed in similar prior transactions by the buyer and were inapplicable
- "Combinatorial value" which represented deal-making synergies, but could not be directly eliminated, reduced buyer's transactions costs
 - Court eliminated the synergies by reducing the weight afforded to the comparable transaction approach

Brynwood v. Schweisberger, IL Sup 2009

■ Facts

- *Brynwood owned and managed commercial office building*
- *Shareholders' expected returns in form of appreciation*
- *Company offered to forego sale in return for agreement to convert to S-corp*
- *Company sold building and dissolved corporation*
- *Dissenter claimed that capital gains deduction was not warranted, since he was entitled to going concern value before costs were incurred*

■ Court ruled

- Trial court erred in not deducting capital gains taxes and prof fees in arriving at fair value for the sale of the real estate, as they were foreseeable and ascertainable
- Costs to wind down the corporation occurred after minority shareholder's status was extinguished and should be borne by the remaining shareholders

Murphy v. US Dredging, NY Sup 2008

■ Facts

- *Company sold real estate subject to transfer taxes*
- *Petitioner's expert deducted discounted value of future taxes*
- *Petitioner's expert made no deduction for lack of liquidity*

■ Court ruled

- Dissolution does not constitute a “ready market” in same sense as a buy sell agreement and does not preclude consideration of liquidity discount
- Lack of marketability discount was allowed
- Court cited precedent for valuing corporation as an operating business rather than a business in the process of liquidation (LaSala 2003)
- Given that taxes represented a large portion of corporate assets, present value of discounted taxes was deducted to determine fair value

Notz v. Smith Group WI 2009 (Oppression)

■ Facts

- *Shareholder (Notz) claimed harm due to loss of opportunity from the sale of a high growth subsidiary*
- *Shareholder further claimed harm due to payment for transaction due diligence by the corporation*
- *Shareholder sued for breach of fiduciary duty and dissolution*

■ WI Supreme Court

- Affirmed that first claimed action harmed the corporation, not the individual shareholder, and dismissed the direct claim of breach of fiduciary duty
- Further affirmed that the majority shareholder's appropriation of due diligence paid for by the corporation represented a constructive dividend

Whitehorn v. Whitehorn Farms, MT Sup 2008 (Oppression)

■ Facts

- *Oppressed minority shareholder was employee terminated for cause*
- *Shareholder was also recipient of gifted shares for company that owned and operated farmland*

■ MT Supreme Court (affirmed lower court)

- Failure to pay dividends did not establish oppression, since company had history of not paying dividends
- Employee had no reasonable expectation of continued employment after converting corporate property
- Majority shareholders did not breach their fiduciary duties as employers, as corporate continuity demanded that they terminate employee to protect the corporation
- Because shareholder acquired vast majority of shares by gift, he had no capital investment that would lead to a reasonable expectation of benefit from holding his shares

Ritchie v. Rupe, Tex. App. Dallas (Oppression)

■ Facts

- *Minority shareholder hired broker to help sell shares*
- *Company denied anyone access to management or records*
- *Broker unable to find buyer*
- *Shareholder sued for oppression and forced buyout*

■ Tex. App. Dallas

- Directors refusing to meet potential third-party buyers was oppression
- Whether to include discounts in buyout price – “two types” of fair value
 - Enterprise value: willing buyer, unwilling seller – minority shareholder doesn’t want to leave but forced out
 - Fair market value: willing buyer, willing seller – minority shareholder wants to leave but can’t due to majority’s oppression
- Remedy should be based on oppressive conduct sought to prevent
- In this case, sale at fair market value. Enterprise value would provide “excessive relief”

Observations and the Appraiser's "Burden"

- Understand state-specific statutes, which influence appropriate standard of value and premise of value
- Consider ownership rights and privileges for the subject interest, including shareholder agreements, and if whether they are arm's length
- Know the facts of the case
- Understand the standard of review when analyzing court cases

Questions



AICPA Business Valuation Web Seminar Series: Core Competencies from the Nation's Leading Experts

Upcoming Web Seminars:

- **Pass-through Entity Valuation 2012: Research & Methods** January 19, 2012
- **Forensic Analysis Expert Witness Testimony: Defending Your Expert Report and Expert Testimony** February 2, 2012

For more information visit: www.aicpa.org/BVSeries

Archived recordings of previous events available for FVS Section members.

See You at the Event!

Visit [www.aicpa.org/FVS CPE Events](http://www.aicpa.org/FVS_CPE_Events) to register for the following face-to face educational opportunities in 2012:

■ AICPA Fair Value Measurements Workshop

- March 22-23, 2012 in New York, NY; CPE: 16 credits

■ AICPA National Business Valuation Schools

- May 7-11, 2012 in Chicago, IL; CPE: 45 credits
- June 11-15, 2012 in Atlanta, GA. CPE: 45 credits
- July 23-27, 2012 in New York, NY. CPE: 45 credits

■ AICPA Fair Value Measurements and Reporting Conference

- June 6-8, 2012 in National Harbor, MD. CPE: 16 credits (est.)

■ AICPA National Forensic and Valuation Conference

- November 11-13, 2012 in Orlando, FL. CPE: TBD

For additional information, please visit:

- **AICPA Forensic and Valuation Services (FVS) Section**
www.aicpa.org/fvs
- **Accredited in Business Valuation Credential Overview**
www.aicpa.org/abv
- **Certified in Financial Forensics (CFF) Credential Overview**
www.aicpa.org/cff

Thank You!