

Valuation Discounts in Dissenting Shareholder Appraisal Rights and Shareholder Oppression Claims

Matt C. Courtnage

In statutory shareholder appraisal rights and shareholder oppression matters, various state statutes and judicial precedent provide conflicting guidance as to the measurement of fair value. For the most part, shareholder appraisal rights matters—and shareholder oppression matters—typically involve the fair value of equity shares determined without consideration of valuation discounts. In certain matters, however, there is judicial precedent for the inclusion of a valuation discount. This discussion focuses on fair value valuation analyses, and this discussion provides examples of judicial decisions regarding the application of valuation discounts in statutory fair value matters.

INTRODUCTION

A shareholder appraisal right is a statutory remedy that is available in a majority of states. By definition, this statutory remedy is intended to compensate noncontrolling stockholders who object to certain actions taken by the corporation. These statutory shareholder appraisal rights provide an option to the dissenting shareholders that generally requires the corporation to purchase the dissenting shareholders' stock.

In a statutory appraisal rights valuation, the typical definition of value is fair value. Fair value is generally defined as the pro rata business enterprise value—a total equity value that is not discounted for lack of marketability or lack of ownership control. This fair value is equivalent to the corporation's pro rata value immediately prior to the corporate action to which shareholders are dissenting.

A majority of states have enacted their own statutes regarding shareholder appraisal rights. Many of these statutes provide guidance as to the appropriate definition of fair value. There is considerable similarity in the fair-value-related terminology between the states.

However, there can also be certain differences in fair-value-related terminology from state to state. Furthermore, certain statutory language allows for substantial judicial discretion in interpreting fair value on a case-by-case basis.

This discussion addresses the application of a discount for lack of control ("DLOC") and a discount for lack of marketability ("DLOM") in statutory appraisal rights valuations. This discussion focuses on the interpretation of fair value in shareholder appraisal rights matters.

More specifically, the judicial decision examples discussed herein illustrate the extraordinary considerations that may allow for the application of valuation discounts despite the generally accepted meaning of fair value.

DISSENTING SHAREHOLDERS AND SHAREHOLDER OPPRESSION

Dissenting shareholders can invoke statutory appraisal rights in certain business-related transactions. These transactions typically include a merger,

the sale of substantially all the corporate assets, a recapitalization, amendments to the articles of incorporation, or other significant changes that affect their investment in the corporation.

Typically, a corporation's board of directors is required to give notice of a contemplated corporate action from which noncontrolling shareholders may dissent. If a noncontrolling shareholder(s) dissents from the corporate action, the dissenting shareholder(s) will then:

1. decline the subject consideration related to the corporate action and
2. demand a payment of fair value for their shares in a notice to the board of directors.

The notice is typically provided before the corporate action is implemented.

This demand initiates the appraisal rights action in which the dissenters lose all rights to the corporation, except the right to receive the payment of the fair value of their company shares.

Shareholder oppression actions taken by noncontrolling shareholders typically result from:

1. claims of unfair treatment by the controlling shareholder(s) and
2. demands for the dissolution of the corporation or a buyout of their shares due to the alleged unfair treatment.

The oppressed shareholders are required to prove that the controlling shareholder(s) excluded them from their proper share of the benefits of corporate ownership. If the court concludes that acts of shareholder oppression did occur, then the corporation will likely have to pay the fair value per share to the oppressed shareholders.

FAIR VALUE DEFINED

Fair value has been defined in numerous jurisdictions and in the legal literature. Certain definitions of "fair value" are summarized below.

When the courts determine the noncontrolling share price in an appraisal rights action or in an order for the buyout of an oppressed noncontrolling shareholder, typically the price of the award or buyout is the "fair value" as determined by the court.¹

The model statutes proposed by the American Bar Association ("ABA") and the American Law Institute ("ALI"), combined with the Delaware appraisal statutes, have had a significant influence on individual state statutes regarding fair value.

The Model Business Corporation Act ("MBCA") of 1984 is a frequently cited source to provide the definition of the fair value standard of value. The MBCA defines fair value as follows: "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."²

In 1999, the MBCA revised the definition of fair value as follows:³

1. The value of the corporation's shares determined:
 - a. immediately before the effectuation of the corporate action to which the shareholder objects;
 - b. using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and
 - c. without discounting for lack of marketability or minority status except, if appropriate, for amendments to the articles pursuant to section 13.02(a) (5).

The ALI has defined fair value as follows:⁴

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.

Extraordinary circumstances exist when a court finds that a dissenting or oppressed shareholder is trying to exploit a transaction to divert value that could not be made available proportionately to other shareholders. The Lawson and the Balsamides cases . . . are defined by the guiding principle that a marketability discount cannot be used unfairly by the controlling or oppressing shareholders to the detriment of the minority or oppressed shareholders. Equitable considerations generally state that minority discounts should not be applied in determining the FV of a minority shareholder's stock when the corporation or the majority stockholders elect or are compelled to purchase the minority interests. This is based upon the rationale that when a party already in control purchases a minority's shares, it is irrelevant that the shares represent a noncontrolling interest.



1. The measurement of fair value
2. The application of discounts in shareholder appraisal rights proceedings

NEW JERSEY CASE— *PARKER V. PARKER*⁶

In 2016, the New Jersey Superior Court found that it was appropriate to apply a DLOM to the value of a private company stock. The case involved the determination of a buyout price for the oppressed shareholder to purchase the interest of the oppressive shareholder. To that end, a 25 percent discount was applied to the undiscounted fair value estimate.

New Jersey is generally considered a fair value jurisdiction. In situations where shareholder oppression has been determined, DLOCs and DLOMs are typically not applied.

New Jersey protects the interest of noncontrolling shareholders in private corporations under the Oppressed Minority Shareholder Statute, N.J.S.A. 14A:12-7.

Specifically, N.J.S.A. 14A:12-7(1)(c) safeguards noncontrolling shareholders from “oppression,” “abuse” or “unfair” treatment by the majority (acting as officers or directors), in the noncontrolling shareholders’ “capacities as shareholders, directors, officers or employees.” The remedies provided to noncontrolling oppressed shareholders include appointing a custodian, appointing a provisional director, ordering a sale of the corporation’s stock, or dissolving the company.⁷

There is an exception for “extraordinary circumstances” when the circumstances of a particular case are unique to a given entity and would warrant the application of certain discounts. In this case, the trial court found that the oppressive shareholder enabled a situation that warranted a DLOM in order to achieve what the court stated was a “fair and equitable” outcome.

Background of the Case

Richard and Steven Parker, brothers, were 50/50 owners of a wholesale flower and garden center company. Richard ran the flower business and Steven managed the garden business—with very little overlap in operations between the two lines of operations.

Under Delaware law, fair value guidance was set forth by the Delaware Supreme Court in *Tri-Continental Corp. v. Battye*.⁵ In that decision, the Supreme Court explained that:

The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern. By value of the stockholder’s proportionate interest in the corporate enterprise is meant the true or intrinsic value of his stock which has been taken by the merger. In determining what figure represents this true or intrinsic value, the appraiser and the courts must take into consideration all factors and elements which reasonably might enter into fixing the value.

What is notable among these three definitions of fair value is the ALI inclusion of “extraordinary circumstances” and the Delaware guidance to “take into consideration all factors and elements which reasonably might enter into fixing the value.”

Appraisal rights statutes diverge across the states on many aspects, including the definition of fair value and the applicability of a DLOC and a DLOM in a fair value determination. In some states, there are no specific statutes regarding dissenting shareholder appraisal rights and shareholder oppression.

The following discussion summarizes three judicial decisions. These decisions illustrate how individual states and the presiding courts address the following issues:

Over a 25-year period, the brothers' working relationship dissolved to the point that the presiding judge wrote: "Both litigants seek to have the court remedy every injustice they perceive has befallen them over the last 25 years at the hand of the other."

Each brother accused the other brother of misconduct. This misconduct included numerous charges of corporate mismanagement, financial misconduct, and being frozen out from the business.

The Parker Decision

The court sided with Richard, finding that Steven was guilty of oppressive conduct with regard to his dealings with his brother. Specifically, the court found that Steven had engaged in shareholder oppression by:

1. allowing the business to incur substantial losses over the life of the business and
2. withdrawing funds from the business without the consent of Richard.

The court concluded that Steven had violated his fiduciary duties as director of the company, and the court ordered Steven to sell his interest in the company to Richard.

Both parties retained valuation analysts to estimate the value of Steven's business interest. The court, apart from a few adjustments, accepted the value conclusion of Richard's analyst—which included a 25 percent DLOM applied to Steven's undiscounted ownership fair value. Interestingly, the court rejected an additional 15 percent DLOC, stating that New Jersey's "no-discount-absent-exceptional circumstances rule."

In terms of the application of the 25 percent DLOM, the court stated the following:

The court believes a marketability discount should be applied. The actions of the defendant [Steven] were the cause of the lawsuit. He cannot be rewarded by not applying this discount. In cases where the oppressing shareholder instigates the problems, as in this case, fairness dictates that the oppressing shareholder should not benefit at the expense of the oppressed. . . . In this matter, Steven Parker's wrongful act caused an extraordinary circumstance which requires this court to apply a marketability discount. Steven Parker, the oppressing shareholder, cannot receive a windfall as a result of his actions, the marketability discount will be applied.

Related Valuation Issues

In the case of *Parker v. Parker*, the court allowed the application of a valuation discount (in this instance, a DLOM) as a penalty tool. It appears that this penalty tool was applied due to the wrongful behavior of the oppressive shareholder.

The application of the DLOM by the court seems to have created more questions than answers for both analysts and counsel. The controversial issues raised by the decision include the following:

1. Why was the application of a DLOM allowed but not a similar application of a DLOC?
2. How is the definition of a DLOM consistent with a legal penalty?
3. Should the penalty for oppressive shareholder behavior be left entirely to a judge's discretion?
4. If the situation were reversed, such that Steven (the oppressive shareholder) was instead buying out the interest of Richard (the oppressed shareholder), would the DLOM have still been applied?

COLORADO CASE—PUEBLO BANCORP. V. LINDOE, INC.⁸

In 2003, the Colorado Supreme Court ruled that, by virtue of a noncontrolling shareholder's specific holding, a DLOM is not to be applied to the shareholder level. The court ruled that the corporation is to "be valued as a going concern" and that neither marketability nor noncontrolling discounts should be applied when valuing a dissenter's shares.

The *Pueblo* decision established that a dissenting noncontrolling shareholder's fair value is his or her proportionate interest in the corporation on a strictly pro rata basis. This valuation is made



without the inclusion of a discount based on a specific noncontrolling share ownership.

The Colorado dissenters rights statute is based on the MBCA.18 CRS § 7-113-101(4). The provision is based on the 1984 MBCA, which states:

Fair value, with respect to dissenters' shares, means the value of the shares immediately before the effective date of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action except to the extent that exclusion would be inequitable.⁹

Background of the Case

Pueblo Bancorp. ("Pueblo") and Lindoe Inc. ("Lindoe") were both C corporation bank holding companies. Lindoe held 6,525 of the 114,217 outstanding shares of Pueblo. To obtain more favorable income tax treatment, Pueblo formed a subchapter S corporation into which it would merge.

Shareholders such as Lindoe that did not qualify for S corporation share ownership were offered a cash buyout. Lindoe believed the offer price undervalued the company's value. Lindoe dissented and filed a shareholder appraisal rights action.

The Pueblo Decision

The initial trial court concluded that the Lindoe shares should be equal to the company's proportionate share of the corporation at fair value less a 30 percent combined DLOC and DLOM.

The court concluded that the combined discount was applicable in this case. This was because Lindoe's stockholding was a noncontrolling position in Pueblo. According to the court, the Pueblo noncontrolling position was perceived to be extraordinary difficulty to sell.

Lindoe appealed the trial court ruling. The Colorado Court of Appeals affirmed the trial court fair value determination but ruled against the application of either a DLOC or a DLOM. The appeals court noted that there was nothing extraordinary in regards to the matter at issue and thus no discount was warranted. Pueblo appealed this decision, arguing that fair value should be determined on a "case-by-case" basis.

The Colorado Supreme Court agreed with the Colorado Court of Appeals in ruling that no discount should have been applied to the fair value determination. The court concluded that a "case-by-case" interpretation of "fair value" results in a definition that is too imprecise to be useful in the business

community. The court held that fair value should have a "definitive meaning" and that such meaning is different than "fair market value."

In summary, the court concluded the following:

1. The concept of fair value implied no provision for a DLOC or a DLOM.
2. Its finding was consistent with the underlying purpose of the dissenting shareholder appraisal rights statute.
3. Its finding was consistent with the national trend against applying valuation discounts.

Related Valuation Issues

The *Pueblo v. Lindoe* case established that "fair value" for issues involving dissenter's rights is the proportionate value of the entity "valued as a going concern." This interpretation and application of fair value is consistent with the majority of courts that have considered the issue.

While the Colorado Supreme Court primarily relied on the Colorado dissenters' rights statutes and the court's interpretation of how to define fair value in the subject case, the court did address the issue of extraordinary circumstances. The court noted that the facts of the case did not lend to any findings of extraordinary circumstances attributable to the dispute and was thus not applicable in this case.

In other words, the court's ruling effectively left open the issue of whether extraordinary circumstances are applicable under Colorado law. If extraordinary circumstances are applicable under Colorado law, then the application of DLOC and DLOM may be considered appropriate.

NEW YORK CASE—FEROLITO V. ARIZONA BEVERAGES USA LLC¹⁰

In 2014, a New York trial court ruled that, based on extraordinary circumstances involved in *Ferolito v. Arizona Beverages USA LLC* (the "Ferolito" case"), a 25 percent DLOM was applicable. The 25 percent discount was applied to estimate the business enterprise fair value—used to calculate the buyout amount to be paid to the plaintiff, Ferolito.

The decision in the *Ferolito* case was controversial in its own right, but especially given that, just a week prior, a New York trial court disallowed the application of a DLOM in a noncontrolling dissenting shareholder case.¹¹

In that case, the court opined that the application of a DLOM to the noncontrolling shareholder

ownership interest would be tantamount to the imposition of a noncontrolling discount.

The New York courts have a long history of judicial interpretation of Section 623(h)(4) of the Business Corporation Law, which makes no reference to discounts in its text. The statute reads:

In fixing the fair value of the shares, the court shall consider the nature of the transaction giving rise to the shareholder's right to receive payment for shares and its effects on the corporation and its shareholders, the concepts and methods then customary in the relevant securities and financial markets for determining fair value of shares of a corporation engaging in a similar transaction under comparable circumstances and all other relevant factors.



Background of the Case

At the time of the judicial decision, AriZona was the largest privately owned beverage company in the United States. The company was founded in 1992 by Ferolito (the plaintiff) and Vulaggio (the defendant).

The various companies that made up AriZona Beverages sold iced teas, lemonade-tea blends, and assorted fruit juices primarily under the AriZona Iced Tea brand name.

Ferolito and Vulaggio each owned 50 percent of the stock upon the founding of the company and as of the date of the trial. The two partners began to disagree about matters regarding the company's operations early on in their partnership.

The decision was made to allow Vulaggio to handle the day-to-day decision making for the company. In addition, the owner's agreement was amended to limit the transfer of shares in AriZona to only a specified class of transferees.

Between 2005 and 2010, two companies expressed interest in acquiring part or all of AriZona. The first suitor was Tata, the second largest tea manufacturer in the world. At some point, Tata estimated that AriZona might be worth \$4.5 billion in its entirety, but negotiations broke down and no formal offer was made.

Nestlé expressed interest in buying Ferolito's 50 percent ownership. The Nestlé offer of \$1.45 billion

for the 50 percent ownership was conditioned on additional due diligence. The Nestlé offer included the option to also purchase the 50 percent ownership held by Vulaggio. However, the Nestlé discussions failed to provide a bona fide offer, and the proposed transaction fell apart.

Ferolito argued that a combination of (1) the transfer restrictions in the ownership agreement and (2) the unwillingness of Vulaggio to release detailed financial data precluded Ferolito from selling his shares at a fair value. Ferolito sued the company for dissolution.

The Ferolito Decision

In the judicial decision, the trial court judge stated that the DLOM "reflects that shares in privately held companies may be less marketable because those shares cannot be liquidated for cash."

The court concluded that there were numerous obstacles for either shareholder to liquidate their shares and, consequently, there was sufficient rationale to apply a 25 percent DLOM.

The justification for the 25 percent DLOM was based on the following rationale:

1. Despite his interest in selling, the plaintiff had not been able to sell his shares in the past
2. AriZona did not have sufficient audited financial statements
3. History of extensive litigation between the shareholders

“Unfortunately, there is no default rule as to whether discounts can be applied in dissenting shareholder appraisal rights or shareholder oppression valuations.”

4. Uncertainty regarding the company’s S corporation status
5. Transfer restrictions in the Owner’s agreement

The judge in the case ruled against the application of a noncontrolling discount for the same reason that most fair value decisions do not allow either a DLOM or a DLOC. The court justified not applying a noncontrolling discount by citing a New York case, *Friedman v. Beway Realty Corp.*¹² which stated:

[A] minority discount would necessarily deprive minority shareholders of their proportionate interest in a going concern would result in minority shares being valued below that of majority shares, thus violating our mandate of equal treatment of all shares of the same class in minority stockholder buyouts.

Related Valuation Issues

The *Ferolito* decision seems to establish that a DLOM may be applicable in a dissenting shareholder fair value determination. At the same time, the decision disallowed a DLOC because courts typically do not allow either a DLOC or DLOM in dissenting shareholder rights and shareholder oppression cases.

From the vantage point of the plaintiff, it would seem that the application of any discount in a buyout scenario is a loss for the seller and an offsetting gain for the buyer, regardless of whether the discount was a DLOC or a DLOM.

This judicial decision highlighted that, at least in New York, (1) decisions are made on a case-by-case basis, (2) a DLOM is more likely to be applicable than a DLOC in a shareholder appraisal actions, and (3) the definition of extraordinary circumstances is open to interpretation.

SUMMARY AND CONCLUSION

The vast majority of state statutes and judicial decisions are based on the concept that the noncontrolling shareholder’s value should be determined as a pro rata share of the total business enterprise

value—without the application of a DLOC or a DLOM at the shareholder level.

Nonetheless, the statutory definition of fair value often differs between states, and such definitions offer language such as “extraordinary circumstances” or “case-by-case basis.” That language allows for judicial discretion when it comes to allowing the application of shareholder level discounts.

The three judicial decisions presented in this discussion highlight the degree to which courts consider—and sometimes apply—shareholder discounts in appraisal rights proceedings.

Unfortunately, there is no default rule as to whether discounts can be applied in dissenting shareholder appraisal rights or shareholder oppression valuations. Individual state statutes, relevant judicial decisions within a particular state, and the circumstances of individual cases should all be considered in the application of a DLOC or a DLOM in a statutory appraisal rights valuation.

Notes:

1. Douglas K. Moll, “Shareholder Oppression and ‘Fair Value’: Of Discounts, Dates, and Dastardly Deeds in the Close Corporation,” 54 *Duke Law Journal* 293, 310 (2004).
2. MBCA Section 13.01(3) (ABA 1984).
3. Model Business Corporation Act § 13.01(4) (ABA 1999).
4. American Law Institute, *Principles of Corporate Governance*, 1992, at § 7.22.
5. *Tri-Continental Corp. v. Battye*, 74 A.2d 71 (Del. 1950).
6. *Parker v. Parker*, UNN-C-108-13, 2016 N.J. Super Unpub. LEXIS 2720 (N.J. Dec. 22, 2016).
7. N.J.S.A. 14A:12-7(1).
8. *Pueblo Bancorp. v. Lindoe, Inc.*, 37 P.3d 492, (Colo. App. 2001) aff’d, 63 P.3d 353 (Colo. 2003).
9. <http://www.duree.com/images/pdfs/06JuneBusinessLaw.pdf>
10. *Ferolito v. Arizona Beverages USA LLC*, No. 004058-12, 2014 WL 5834862 (N.Y. Sup. Oct. 14, 2014).
11. *Zelouf Intl. Corp. v. Zelouf*, 999 N.Y.S.2d 731, (N.Y. 2014)
12. *Friedman v. Beway Realty Corp.*, 87 N.Y.2d 161 (N.Y. 1995).

Matt Coutnaga is a manager in our Portland, Oregon, practice office. Matt can be reached at (503) 243-7520 or at mccourtage@willamette.com.

