Business Divorce Fair Value – To Discount or Not

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When business owners decide to "divorce" from their co-owner(s), the value of the business must always be determined. In a business divorce the equity interest of one or more of the co-owners is almost always purchased by the remaining co-owners. Several important valuation issues arise in this situation including the appropriate standard (definition) of value to be applied and the terms of any buy-sell agreement. The purpose of this article is to set forth some common valuation issues presented in business divorce cases and to explore factors that may indicate whether discounts for lack of control and lack of marketability may be appropriate.

Standard of Value

"Fair market value" is defined as "the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms-length in an open and unrestricted market, when neither is under any compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."[1] Under this standard, the value of the co-owner's interest in the business is subject to discounts for lack of control and marketability. These combined discounts can total as much as 40% or more of the values indicated by the valuation methods applied. Utilization of this standard may not be fair to the departing co-owner as it may unjustly reward the remaining co-owner(s) at the expense of the departing co-owner(s). "Fair Value" is another standard of value that may be applied.

"Fair Value" is specifically defined by state statute in connection with corporate actions involving dissenting shareholders. A shareholder is entitled to dissent from and obtain payment of the fair value of the shareholder's shares of stock under various circumstances in Arizona. Statutory fair value is defined for this purpose as "…the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion is inequitable."[2] A minority shareholder has the right under certain circumstances to file an action for judicial dissolution of the corporation. To avoid dissolution the remaining

[1] Definitions, Statement on Standards for Valuation Services No. 1 (SSVS No. 1), issued by the AICPA Consulting Services Executive Committee, American Institute of Certified Public Accountants, June 2007.
[2] Sec. 10-1301 Arizona Revised Statutes

shareholder(s) may elect to purchase the shares owned by the minority (oppressed) shareholder that petitioned for dissolution, at the fair value of the shares. Fair value is not specifically defined for this purpose. The original source of the language of the above-referenced Arizona statutes regarding "Fair Value" is the Revised Model Business Corporation Act (the "Model Act") as it existed in 1994. In Arizona, there is no statutory definition of fair value for similar actions regarding businesses organized as partnerships or limited liability companies.

Pro Finish Case

Arizona case law did not address the issue of "Fair Value" in the context of dissenting shareholder cases until 2003 when the Court of Appeals of Arizona, Division 1, considered the case of Pro-Finish USA, Ltd.[3] In that case a group of minority shareholders dissented to the sale of substantially all the assets of a closely-held corporation and then exercised their rights to require the corporation to purchase their shares. The corporation initially set fair value at $1,200 per share and paid that amount, plus interest, to the shareholders. The dissenting shareholders' expert determined the fair value (at approximately $2,500 per share) based on the asset sale price. The corporation's expert determined a lower fair value (at approximately $1,000 per share) based on expected future earnings of the business and included discounts for lack of control and marketability. The lower court accepted the higher value and the Company appealed.

In affirming the decision of the lower court, the Court determined that fair value should not exclude the asset sale price since to exclude it would be inequitable to the dissenting shareholders. In addition, the asset sale did not cause any appreciation and, third-party sales are the best evidence of value. Further support for the Court's interpretation was found in the Principles of Corporate Governance: Analysis and Recommendations (1994) (hereinafter the "Principles"), a comprehensive study by the American Law Institute.

Section 7.22 of the Principles sets forth standards for determining fair value and states that, except for circumstances not present in the case, "…the aggregate price accepted by the board of directors of the subject corporation should be presumed to represent the fair value of the corporation, unless the [opposing party] can prove otherwise by clear and convincing evidence." [4] The Principles also note that "…management generally has every incentive to obtain the highest possible price in a true arm's-length transaction."[5] A more recent version of the Model Act also adopts this approach as did the Court in this

[3] PRO-Finish USA, Ltd. V. Johnson, 1 CA-CV 02-0091 (63 P.3d 288 (Ariz. App. Div. 1, 2003)
[4] Section 7.22 (b), Principles of Corporate Governance: Analysis and Recommendations (1994), a comprehensive study by the American Law Institute.
[5] Ibid, at Comment c.

case. The approach of the Court likely would have been different had there been a stock-for-stock merger rather than a sale.

The Court also confirmed the lower court decision to exclude discounts for lack of control and marketability stating "…the focus is upon the value of the firm as a whole, and that value should be prorated equally in the appraisal process"[6] The Court also noted that the Principles also state that the value of the dissenters' proportionate interest is to be determined "…without any discount for minority status or, absent extraordinary circumstances, lack of marketability."

The 1999 Amendment to the Model Act also set forth the following guiding principle. Fair value is to be determined using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal and, generally, without discounting for lack of marketability or minority status.

The Pro Finish case deals with a dissenting shareholder action in which substantially all the assets of the business were sold. I would expect that the Court would rely heavily on the Principles in deciding a dissenting shareholder case in a stock for stock merger or in a minority oppression case under the judicial dissolution statute. However, the above case and Arizona statutes deal with corporations. There is no counterpart in the partnership or LLC statutes in Arizona and, therefore, no statutory framework or guidance for the appropriate standard of value to be applied in business divorces for those forms of organization. In addition, there has been no guidance in Arizona case law regarding what constitutes "extraordinary circumstances" under the exception to application of marketability discounts.

Extraordinary Circumstances

The Superior Court of New Jersey, Appellate Division, recently dealt with the issue of the applicability of a discount for lack of marketability in an oppressed shareholder case (Wisniewski v. Walsh).[7] New Jersey law authorizes a court, within its sound discretion, to order a sale of any shareholder's stock to the extent fair and equitable under the circumstances. It specifies that "…the purchase price of any shares so sold shall be their fair value…"[8] Therefore the New Jersey courts have the discretion to order the sale of the oppressor's shares of stock to the oppressed shareholders in these cases. In Arizona, it is generally the oppressed minority shareholder whose stock is purchased at fair value by the corporation or its remaining shareholders.

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[6] PRO-Finish USA, Ltd. V. Johnson, 1 CA-CV 02-0091 (63 P.3d 288 (Ariz. App. Div. 1, 2003), at p. 12
[7] Wisniewski v. Walsh, 2013 N.J.Super. (Unpub.) LEXIS 724 (April 2, 2013).
[8] N.J.S.A. 14A:12-7(8)

In the Wisniewski case, three siblings (Patricia, Frank and Norbert) each owned a 1/3 interest in the family business. Frank had been operating the company for many years and served as its CEO. Norbert joined the company as a truck driver the same year Frank took over leadership. Frank got into some trouble and served prison time for commercial bribery and bank fraud, among other charges. During this time, Norbert assumed leadership although Patricia's husband, Raymond, also served as an officer of the company. Once his time was served, Frank resumed his leadership role in the company.

During Norbert's leadership he discontinued paying bills of Patricia and Raymond that had been routinely paid prior to that time. This action required them to obtain 2nd mortgages on their home and to sell assets in order to meet their obligations. Norbert also ordered an accounting transfer of billings from a company in which all the parties had a nominal interest to a subsidiary in which Patricia then had no interest. This action was taken without consulting or compensating Patricia. Norbert further excluded Patricia and Frank from a real estate deal by purchasing the property through an entity owned by Norbert's immediate family. The trial judge used these actions as the basis to find that Norbert was the oppressor.

The trial court ordered Norbert to sell his interest in the company at its "fair value" to either the corporation or the remaining shareholders. After briefly describing a marketability discount, the Appellate Court noted that "In forced buy-out circumstances, such a discount is not applicable except under extraordinary circumstances."[9] Citing a previous case, they also noted that the "…unfairness of using [marketability] discounts lies in the potential for depriving minority shareholders of the full proportionate value of their shares and enriching majority shareholders by allowing a buy-out of minority interests at bargain prices." The Appellate Court also observed that "The determination of whether circumstances exist to warrant application of the discount in a particular matter must be guided by considerations of fairness and equity."[10]

Citing a previous New Jersey case (the Balsamides case[11]) the Appellate Court quoted that decision: "…where the oppressing shareholder instigates the problems,…fairness dictates that the oppressing shareholder should not benefit at the expense of the oppressed. Further, any less solution would permit the statute to become an instrument for oppression." The Balsamides court noted that, were the oppressed shareholder ordered to buy out the oppressor at a value without any discount for lack of marketability, the innocent party would inequitably be forced to shoulder the entire burden of the asset's illiquidity. The oppressing shareholders, whose unlawful behavior occasioned the forced sale in the first place would have received the undiscounted proportional value of his share of the company, while the oppressed shareholder would be forced to accept a discounted price in any future sale to a third party.

[9] Wisniewski, supra, at page 30.
[10] Ibid, at page 31.
[11] Balsamides v. Protameen Chemicals, 160 N.J. 352 (1968).

The Balsamides court concluded that equity demanded application of a marketability discount to the purchase price to ensure that the oppressing shareholder would not be rewarded at the innocent shareholder's expense. [12]

The Appellate Court in Wisniewski held that Norbert should not be rewarded when his conduct not only harmed the other shareholders but necessitated the forced buyout. It then remanded the case back to the lower court to determine the amount of the marketability discount. [13] The result in Wisniewski would not be unlike a minority oppression case in which the oppressed shareholder is bought out with no marketability discount allowed. In both cases the oppressor shareholders would not be rewarded at the expense of the oppressed shareholders to the extent of any marketability adjustment.

Other Adjustments

Similar considerations could impact the applicability of other valuation adjustments. For example, in developing the rate of return utilized to convert future cash flows to value under the income approach to valuation, appraisers often adjust the capital structure to industry levels of debt and equity. This adjustment can have a significant impact on value since the cost of debt is usually much lower than the cost of equity. The higher the level of debt assumed in the capital structure, the lower the overall cost of capital. Since the cost of capital is used as a divisor to the cash flow stream being converted to value, the lower the cost of capital, the higher the value.

If the company being valued has no debt and the industry typically has 50% debt in its capital structure, the initial reaction would be to adjust the actual level of debt to the industry levels. This is generally appropriate when valuing a 100% controlling interest. However, if the company has always been debt-free, has no plans to incur debt and has other significant risk factors making the use of debt even riskier, why should an oppressor obtain the benefit of a lower capital structure (and a resulting higher value) at the expense of the oppressed shareholder? This issue is exacerbated by the typical requirement of personal guarantees for loans to closely-held companies.

Summary

A discount for lack of marketability may be appropriate in determinations of statutory fair value in dissenting shareholder and minority shareholder oppression cases. Other valuation adjustments may also be appropriate depending on the particular facts presented. These principles may also be helpful in actions involving business entities other than corporations, such as partnerships and limited liability

[12] Ibid, at p. 382-83.
[13] Wisniewski, supra, at page 32

companies. However, there is no requirement for the use of "fair value" in cases involving entities other than corporations based on current Arizona statutes.

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