New Jersey Law Journal

VOL. CXCIV - NO.5 - INDEX 510 NOVEMBER 3, 2008 ESTABLISHED 1878

IN PRACTICE

BUSINESS LAW

'Fair Value' and Discounting in N.J. Shareholder Oppression Case

Amorphous standard that has proved to be fertile ground

BY MICHAEL L. RICH

The New Jersey Oppressed Shareholder Statute (the "Act"), N.J.S.A. 14A:12-7(1)(c), allows an oppressed minority shareholder in a closely held corporation having 25 or fewer shareholders to bring suit in the N.J. Superior Court. Once oppression has been established, the Act allows a judge to, inter alia, order dissolution of the corporation or sale of its stock. If sale of the stock is the remedy, the Act allows judicial discretion to structure the sale in a manner "fair and equitable" to all parties, given the circumstances. Typically the court will order the oppressor-majority shareholder to buy out the shares of the oppressed-minority. Where there is to be a sale, the Act requires the judge to price the oppressed-minority's ownership interest at a "fair value" ("FV"). This is where it gets interesting. What is FV? Does FV encompass a minority or marketability discount? Faced with these questions, in 1999 the N.J. Supreme Court in *Balsamides v. Protameen Chemicals, Inc*., 160 N.J. 352 (1999), and *Lawson Mardon Wheaton, Inc. v. Smith*, 160 N.J. 383 (1999), responded that it was not possible to pronounce a consistent rule. Rather, each decision depends on the specific facts of the case, and also should reflect the purpose served by the law in that context. Hence, despite a progeny of cases brought under the Act, we are left with a case-by-case resolution, which is an amorphous standard that has proven to be fertile ground for dispute between valuation experts.

The Supreme Court, in *Balsamides,* addressed the meaning of FV with limited success. Courts in states with similar oppression statutes often look to that state's dissenting shareholder appraisal statute in defining FV. New Jersey is no exception. As the *Balsamides* Court stated, "there is no reason to believe that 'fair value' means something different when addressed to dissenting shareholders than it does in the context of oppressed shareholders." Notice that the Act uses the term "fair value," not "fair market value." While these terms may have similar meanings in other contexts, the difference is quite noteworthy here. FV seeks to adequately compensate shareholders for their interest, while fair market value ("FMV") is the market's judgment of valuation: the price that would be paid "between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell." The two values are rarely equivalent. Until the adoption of the New Jersey Corporation Act in 1968, FMV was the metric utilized in dissenting shareholder valuation. The Act jettisoned FMV in favor of FV to permit judges to have more flexibility in valuation. Be careful what you wish for: this flexibility has opened the floodgates for debate and litigation in oppressed shareholder cases.

New Jersey is not alone in its struggle to define FV. Nationally, interpretation is split between the FMV (hypothetical transaction) approach and that of enterprise value. The N.J. Legislature has apparently opted for something different than FMV with its marked redefinition in the New Jersey Corporation Act. The enterprise value approach sees the oppressed shareholder as an investor with no choice but to cash out his ownership interest. It assumes that, were it not for the adverse conduct by the oppressor, the oppressed would have retained ownership and continued to enjoy benefits commensurate with his or her share of the company. Rather than conjuring up a fairy-tale romance between a fictional buyer and seller of a minority interest in a closely-held corporation, the

Rich is a Principal at Porzio Bromberg & Newman in Morristown and handles complex commercial litigation matters. *The author would like to thank Justin G. Craig, a summer associate of the firm attending the University of Pennsylvania Law School, for his many contributions to this article.*

enterprise valuation claims to run parallel to reality. In this light, the enterprise approach values the company as a whole and then apportions its pro rata value to each shareholder. Excess earnings, discounted cash flow, the formula method, or some combination thereof may be utilized in calculating FV.

Several scholars have proffered that marketability and minority discounts are, by definition, inapplicable to the enterprise value approach. New Jersey courts have acknowledged the potentially perverse results of these discounts in court-ordered buyouts, and generally have precluded them in all but "extraordinary circumstances."

A marketability discount acknowledges the small pool of potential buyers for shares in a closely held corporation. Thus, compared with a publicly traded corporation, a sale will demand increased time and expenditure. These discounts generally range from 30 to 40 percent. While some erroneously equate minority and marketability discounts as synonymous, the two are quite distinct. Even a majority or controlling share in a closely held corporation may be subject to a marketability discount: the size of the interest being sold does not necessarily affect its liquidity.

The problem with marketability discounts in the oppression setting, it is argued, is that there is no lack of liquidity in a court-ordered buyout. The buyer and seller have no choice but to accept the judge's terms. The seller need not expend time or money in search of a potential buyer. This has been labeled the "sale misnomer." See Douglas K. Moll, "Shareholder Oppression and 'Fair Value': of Discounts, Dates, and Dastardly Deeds in the Close Corporation," 54 *Duke L.J.* 293, 319 (2004).

A minority discount recognizes that voting interest, and the likelihood of that interest to control the actions of a corporation, is factored into the valuation of a given share. Data suggests that the difference — the discount — between valuation of a minority and majority share, averages between 29 and 33 percent.

The conditions of a court-ordered buyout are not, however, conducive to a minority discount. The crux of the minority discount is that it reflects the lack of control the buyer will have in the corporation. In oppression buyouts, the oppressor is usually ordered to buy out the oppressed. The oppressor, owning an even greater portion of the company post-buyout, will have increased control over the "bottom line" of the business. Thus, to allow an oppressing buyer to receive a discount, despite greater control, would seem contrary to the reasoning behind a minority discount in most instances.

Perhaps this logic explains the increasing hesitation of judges to apply these discounts. Notwithstanding a small body of case law, marketability and minority discounts have apparently entered a period of dormancy in New Jersey. In *Balsamides*, the Supreme Court applied a marketability discount when an oppressed shareholder was ordered to buy out his oppressor (an unusual result), as the oppressed would suffer the full effects of illiquidity when he eventually sold the company. The court left unresolved the tough question: the applicability of the marketability discount when the oppressor buys out the oppressed. That issue remains undecided. In contrast, in *Lawson Mardon Wheaton*, *supra,* decided the same day as *Balsamides*, the Supreme Court held that marketability discounts should only be applied in dissenting shareholder actions under "extraordinary circumstances." Citing to the ALI Principles of Corporate Governance, the court explained that this exception applies only when the dissenting shareholder attempts to exploit the transaction and gain value that would not have been made available proportionately to the dissenter's fellow shareholders. The *Lawson* Court made clear that a mere "family feud," as was the case there, was anything but extraordinary.

A theme of fairness and equity can be deduced from these two cases. Generally, neither a minority nor marketability discount should be applied in either the oppressed or dissenting shareholder contexts absent extraordinary circumstances, nor should a discount be exploited by the controlling or oppressing shareholder to benefit himself or herself to the detriment of the minority or oppressed.

While ambiguities remain in the definition of FV and the status of minority and marketability discounts vis-à-vis the Act, several observations can be made with some certainty. First, FV, as used in the Act, is not synonymous with FMV. Second, marketability and minority discounts are now the exception rather than the norm. While they may be more applicable when the oppressed buys out the oppressor, as in *Balsamides*, that is not the typical scenario. Third, the court generally will not permit the oppressor or party with "unclean hands" to exploit these discounts to his or her advantage. There is ample scholarship arguing inherent contradiction between these discounts and court-ordered buyouts. Perhaps their decreasing application evinces the courts' tacit acceptance of these arguments. ■