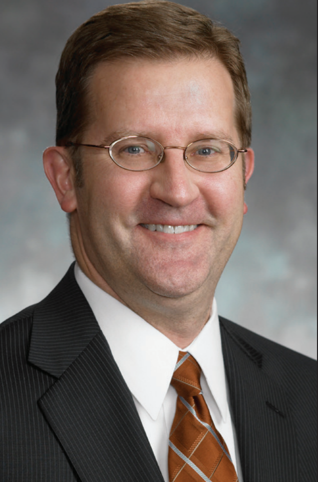

Is "Fair Value" Really Fair?

By Randy Gullickson

Randy Gullickson is a shareholder of Anthony Ostlund Baer & Louwagie P.A. For over 25 years, he has represented businesses and business owners in a wide variety of business disputes in state and federal courts and arbitration proceedings. A significant portion of Randy's practice is focused on the resolution of disputes between and among shareholders, officers and directors of closely held corporations, limited liability companies, and partnerships. A graduate of the University of Minnesota Law School, he has frequently lectured on topics including shareholder rights and litigation, corporate governance, and business valuation disputes. Contact Randy G. Gullickson at rgullickson@aoblaw.com or 612.349.6969.

Fairness, like beauty, is often in the eye of the beholder. That is certainly true in many disputes over the "fair value" of shares of stock in a private, closely held corporation (or limited liability company). More than a decade has passed since the Minnesota Supreme Court defined "fair value" under the Minnesota Business Corporations Act, and surprisingly few reported decisions have seriously examined the issue since then.

Courts determine the fair value of corporate stock most often in two types of shareholder disputes: **(1)** cases under Minn. Stat. § 302A.751 where the court grants a buy-out remedy upon a showing of certain triggering events such as fraud or "unfairly prejudicial" conduct against a minority shareholder; **(2)** dissenter's rights disputes under Minn. Stat. § 302A.471-.743, in which shareholders who dissent from certain fundamental corporate actions, such as mergers, are entitled to payment for their shares. "Fair value" is the price to be paid in dissenter's rights cases, and is the price paid upon a court-ordered buy-out under Section 751, at least in the absence of (and sometimes despite the existence of) an applicable buy-sell agreement.

Perhaps recognizing that the task of placing a value on stock in a closely held company is complex, the legislature did not define fair value and instead granted trial courts exceedingly broad discretion in determining fair value in a particular case. According to the official Reporter's Notes, a court "may use any valuation method or combinations of methods it sees fit" in determining fair value and "[n]o method [of valuation] is recommended because the different methods of measuring value (market, book, replacement, capitalization of earnings, etc.) are neither right or wrong, but merely appropriate in different situations."

"Fair value" must be distinguished from "fair market value." Fair market value is generally defined as the price at which shares would change hands between a willing buyer and a willing seller in an arm's length transaction, with neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. In an arm's length purchase and sale of minority shares in a closely held corporation, the trading price would include a minority discount (reflecting the fact that the shareholder has no ability to control corporate affairs) and a marketability discount (reflecting the lack of liquidity or a ready market for the owner to sell shares). In contrast to fair market value, fair value is a statutory term that has been defined by courts to achieve certain policy goals. Discounts that apply in determining fair market value may be precluded (or may only be allowed in some circumstances) in calculating fair value if applying a discount may be inconsistent with the aim of the statute to protect minority shareholders.

In 2000, the Minnesota Supreme Court, in *Advanced Communication Design, Inc. v. Follett*, defined fair value under the MBCA to be a shareholder's "pro rata share of the value of the corporation as a going concern without a discount for lack of marketability [absent extraordinary circumstances]." The "pro rata share" language, like prior rulings of the Court of Appeals, disallows application of a minority discount. The court held, however, that a marketability discount can apply in cases involving "extraordinary circumstances." When applied, this discount can significantly affect the buy-out price – between 35% and 55% based on expert opinions in the *Follett* case.

What facts are sufficient to establish the extraordinary circumstances to support application of a marketability discount? *Follett* provides general principles but leaves many issues regarding the application of those principles to specific circumstances unanswered. Focusing on the "overarching policy" of ensuring a buy-out remedy that is fair and equitable to **all parties**, *Follett* concluded that extraordinary circumstances justifying application of a marketability discount exist where not applying the discount would result in an "unfair wealth transfer" from the remaining shareholders to the selling shareholder.

The *Follett* court called for "maximum flexibility" in determining whether to apply a marketability discount by considering several factors:

1. whether the buying or selling shareholder acted unfairly toward the other or reduced the value of the corporation;

2. whether the oppressed shareholder has other remedies; and

3. whether the price or other buy-out terms would be unfair to remaining shareholders by unduly burdening the corporation.

Follett itself focused primarily on this third factor in determining to apply a marketability discount. Given the financial status of the company and the funds that would be drained through a buy-out at a non-discounted value, the court concluded that a marketability discount was required to avoid placing unrealistic financial demands on the company that would stifle future growth.

By its reference to the first two factors, which relate to the parties' behavior and the availability of other remedies, the *Follett* decision can be seen as a directive to trial courts to use a marketability discount as an equitable adjustment if necessary to achieve a result the court views to be most fair to all. But, while the **measurement** of the discount is based on the price impact of lack of marketability of the stock, **the rationale** for applying the marketability discount generally involves factors having nothing to do with the lack of marketability of the shares.

Because there have been few reported decisions on the marketability discount since *Follett*, lower courts have received limited further guidance as to when, why, and how to apply a marketability discount. In one interesting Nicollet County case (*Daniel S. McGrath v. MICO, Inc., et al.*), a trial court considered the "extraordinary circumstance" doctrine in the context of a request for statutory prejudgment interest on a stock buy-out award. The court did not find that a non-discounted buy-out price constituted an unfair wealth transfer, and therefore declined to apply a marketability discount to the buy-out price. However, in deciding to deny prejudgment interest, the court stated that if prejudgment interest (which at 10% per year would have been several million dollars) was added to the buy-out, it could result in "extraordinary circumstances" requiring consideration of a marketability discount. Another unreported decision by the Court of Appeals (*Helfman v. Johnson*) held that valuation "discounts" other than the minority or marketability discounts – such as a discount based on the lack of non-competes or employment agreements with key employees – are not barred by *Follett*. Additional guidance has been limited.

The concept of fair value, including the potential use of a marketability discount, is intended to grant trial courts broad discretion to reach a fair result under the specific circumstances of any case. Do trial courts always reach the "fair" result when determining value? In most cases, it depends on whom you ask.