New Jersey Law Journal

VOL. CLXXXI – NO. 5 – INDEX 428 AUGUST 1, 2005 ESTABLISHED 1878

CORPORATE LAW

Valuing Stock in Oppressed Shareholder Actions

Courts grapple with when to use a marketability discount to value shares of close corporations

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In a case involving oppressed shareholders within a close corporation, *Balsamides v. Protameen Chemical Companies, Inc.*, 160 N.J. 352 (1999), the New Jersey Supreme Court awarded a marketability discount in valuing the stock. The Court said such a discount was appropriate and necessary to prevent the oppressor from benefiting from his illegal conduct by creating an artificially inflated price for shares that could not be readily sold on the open market.

In the wake of *Balsamides*, courts are still attempting to refine and further amplify the law created in that landmark case.

Marketability Discount

Balsamides involved two 50 percent shareholders who owned a chemical supply company. Plaintiff Balsamides accused defendant Perle of shareholder oppression even though they each owned 50 percent of the company.

The Court found, for purposes of the Oppressed Shareholders Statute, each of the two 50 percent shareholders was a "minority" shareholder since neither shareholder could direct the outcome because each had less than 51 percent ownership, and therefore did not have "control" of the corporation.

The Court said "Fair Value" is not synonymous with "Fair Market Value." The Court further found "fair value" of a company is "factual" in nature, and not a "legal" determination to be reviewed by the Appellate Division. Therefore, the trial court's determination could not be overturned as a matter of law.

The Court determined that the "equities of the case" must be considered in ascertaining the "fair value" during an appraisal of the oppressed shareholder's actions. The Court awarded a marketability discount, a mechanism which reflects the decreased value of stock in a closely held corporation for which there is no readily available market.

The Court overruled a 3-0 vote of the Appellate Division, which while upholding virtually everything below and awarding legal fees, nevertheless remanded the matter for further price evaluation because it opined that Balsamides been awarded the company too cheaply.

In a companion case to Balsamides, *Lawson Mardon Wheaton, Inc. v. Smith*, 160 N.J. 383 (1999), however, the New Jersey Supreme Court did not award a marketability discount. At issue in Lawson was an appraisal to value stock purchased by a corporation from a dissenting shareholder. The Court, liberally construing the applicable statute in favor of dissenting shareholders, held that in the absence of extraordinary circumstances, a marketability discount should not be applied in valuing the shares of the dissenting shareholders, since that position would reward majority shareholders while penalizing minority shareholders. See id. at 402-404.

Since the *Balsamides* decision there have been several cases which attempt to interpret or refine its holdings. Not all of these cases have been totally consistent with the Supreme Court's notion that valuation is a "factual issue," not a legal one. However, many of these cases have upheld and attempted to amplify the basic equitable perspective of *Balsamides*.

In *Cap City Products Co., Inc. v. Valentin Louriero*, 332 N.J. Super. 499

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(App. Div. 2000), the court considered a matter in which the defendant and plaintiff were sole shareholders in a close corporation. Following an attempt to have an arbitrator value the corporation, the defendant claimed that the arbitrator committed an egregious error of law by applying a marketability discount. The arbitrator revised his determination as to value, but ultimately the Chancery Division treated the matter as one seeking enforcement of an arbitration award. The Appellate Division concurred in this characterization citing the standard outlined in *Perini v. Great Bay Hotel and Casino, Inc.*, 125 N.J. 479 (1992). The *Perini* case basically reestablished the rule that arbitration awards can be vacated only for fraud, corruption or similar wrongdoing on the part of the arbitrator.

Thus, the court held, in a statutory appraisal to value the shares of dissenting shareholders, marketability discount should be employed only if justified by "extraordinary circumstances," which the court did not find in the case before it.

In sum, there is no simple answer to the question of whether a marketability discount should be employed in valuing stock in a close corporation. The answer depends in part upon the purpose for which the stock is being appraised. It also depends on the policy underlying any applicable statute and the "equities" of the case which may include the identification of one party as an oppressor and another as an oppressed victim, or one as a dissenting shareholder subject to being "squeezed out" by a dominant majority. See *Cap City Products*, 332 N.J. Super. at 507.

Selecting a Valuation Date

The selection of a valuation date is a critical concern in oppressed shareholder actions. In *Musto v. Vidas*, 333 N.J. Super. 52, 57 (App. Div. 2000), the Appellate Division clarified issues such as what constitutes a "fair and equitable" valuation date; revisited various factors which were considered valuing a closed corporation; and discussed interest that may be awarded by the court, the application of legal fees, and the consideration of "bad faith" in the context of awarding legal fees. In *Musto*, the Court permitted a twist by giving the oppressing shareholder the right to buy out the oppressed shareholder, rather than the more common scenario of the oppressed shareholder purchasing oppressing party's shares. As a consequence, the court determined that a "marketability discount" should not be applied since that would have benefited the oppressing shareholder. However, the *Musto* court made some preliminary determinations as to the appropriate selection of the valuation date in accordance with N.J.S.A. 14A:12-7 et. seq. and stated that the valuation date for ascertaining fair value in

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oppressed shareholder actions should be the date of an action's commencement, or such earlier or later date that the court "deemed equitable," plus or minus any equitable adjustments.

Clearly, the valuation date is a date which resides within the sound discretion of the trial court and it clearly impacts the nature of valuation. The selection of such a date is critical to valuation and also factors into the equitable presumption of valuation dates. For example, it may be wise to choose a valuation date as the date when business geared up or tailed off. Thus it may not be the filing date that is the best or most equitable date to pick as the valuation date.

The *Musto* case further established that a trial judge is not required to find that a defendant acted in "bad faith" to award counsel fees pursuant to N.J.S.A. 14A:12-7 et. seq. The court ruled that the section only requires that shareholder oppression occurred and forced the sale. *Musto* further set forth various factors which should be considered fundamental in valuing a close corporation, including: (1) the nature of the business; (2) its history; (3) the economic outlook; and (4) the condition and outlook of the specific industry in particular. The court further opined that "generally, in valuation proceedings the corporation must be valued as a going concern, which necessitates not only examination of the corporation's earnings but also consideration of the corporation's future prospects." Citing *Universal City Studios, Inc. v. Francis I. DuPont & Co.*, 334 A.2d 216, 218 (Del. 1975).

Finally, the *Musto* court also discussed the awarding of interest, and suggested that interest is defined as "compensation fixed by agreement or allowed by law for the use or detention of money, or the loss of money by one who is entitled to its use," and as "the amount to the lender in return for the use of money." *Black's Law Dictionary* p. 816, 7th Edition, 1999. The term has been defined as "an exaction for past due obligations, and in essence, is in the nature of a penalty" and is compensation for delay in payment. The court then suggested that it was appropriate to award the oppressed shareholder an equitable interest rate in these circumstances. Thus, *Musto* contributed something substantial to the understanding of the *Balsamides* format.

Minority Shareholders

The *Balsamides* decision and subsequent case law have had a substantial impact on minority shareholders. In *Casey v. Brennan*, 344 N.J. Super. 83 (App. Div. 2001), a corporation decided to reorganize and sent a proposed plan and proxy to shareholders providing for the cashing out of minority shareholders. The Appellate Division held that the proposed plan was materially deficient because these shareholders were essentially uninformed as to the consequences of the plan. The court ruled that in a corporate context, the concept of fairness has two basic characteristics, "fair

dealing" and "fair price." Accordingly, where a shareholder's claim of unfairness involves a corporate transaction where directors or majorities stand to realize a personal benefit by buying out the minority shareholders through payment of an unfairly low price, the corporate directors have a fiduciary duty toward the shareholder and the burden of proving that the transaction was fair and equitable to the minority shareholders.

The *Casey* court further opined that because the concept of "fair dealing" implies open candor and truthfulness, it follows that directors do not properly discharge their obligations when a proxy statement is false, misleading and inaccurate. The court also ruled that the fiduciary duties of loyalty, good faith and due care obligate directors to communicate all material information fully, fairly and candidly to stockholders. As a consequence, the Appellate Division ruled that the fair value of the corporate stock had to be determined as of the day prior to the shareholder vote while excluding any appreciation or depreciation resulting from the proposed action. The court further ruled that excluding "control premiums" as an element of "fair value" was not appropriate. It ordered the trial court on remand to consider valuations that "determine the acquisition value of the corporation as a going concern," or that, in effect, determine a sale price for the corporation as a going concern. On remand, the court further directed the trial court not to automatically reject valuation methodologies that involve "control premiums." However, the court warned that there must be an adjustment to exclude from control premiums anticipated synergies or other future effects of the merger. Finally, the judge must consider any method of valuation that is generally acceptable in international communities, and is otherwise admissible in court." *Casey*, 344 N.J. Super. 103.

In reaching its conclusion, the court seemed to be instructing the trial court on factual matters which apply to the reasonable course of valuation. In this sense, the court in *Casey* seems to contravene the *Balsamides* principle which would give the courts discretion to determine the factual issues included in the valuation process. In *Balsamides*, the Appellate Court remanded because it felt the value was too low, but the Supreme Court very clearly felt that the valuation was not too low and it was a factual issue within the purview of the trial court. That concept seems to have been slightly eroded or amended in *Casey v. Brennan*.

Valuing in the Divorce

The *Balsamides* case has been often applied in the context of divorce actions. In *Brown v. Brown*, 348 N.J. Super. 466 (App. Div. 2002), the husband appealed from a divorce judgment. Prior to the divorce, he had worked in a family florist business and over time he developed a large minority interest in the business. During the litigation, he had steadfastly argued that this minority interest was a "gift," while his wife claimed that it was not. The Appellate Division refused to apply a "marketability" or "minority" discount to the valuation of the husband's shares in the corporation for purposes of equitable distribution. The court predicated its position on the fact that there was no transfer of shares in the equitable distribution, and that the discount would unfairly minimize the marital estate to the wife's detriment, a concept expressed as being inconsistent with equitable distribution.

The court cited *Balsamides* for the proposition that valuing the shares of a close corporation is not an exact science, and also accentuated the difference between a "marketability discount" and a "minority discount." A "marketability discount" adjusts for lack of liquidity of one's interests in an entity on the theory that there is a limited supply of potential buyers for stock in a closely held corporation. A "minority discount" adjusts for lack of control over the business entity on the theory that noncontrolling shares of stock are not worth their proportionate share of the firm's value because they lack voting power to control corporate actions. Just as in *Casey*, the court determined that such discounts should not be applied absent "extraordinary circumstances."

It appears that the *Brown* court incorrectly mixed apples with oranges. The problem with the *Brown* court's decision is that it confuses principles of "equitable distribution" with the concept of "valuation of close corporations." Rather than incorporate principles of equitable distribution into the valuation process, which appears to be the case in *Brown*, the court should have objectively assessed the "fair value" of the husband's business and then allocated value to the husband and wife on the basis of equitable distribution principles. Once the court objectively arrived at the value of the business independently, only then should the court apply whatever equitable distribution principles it deems appropriate. However, the valuation process should remain separate and sacrosanct. Unfortunately, it appears that the *Brown* court has, to some extent, intertwined those two issues, and in the course of doing so, it has muddled the law. The value of a business is subject to equitable distribution just as any other marital asset, i.e., a house, a car, jewelry, etc.

Certainly, it may be harder and more complicated to value a business, but once valued it is essentially like any other asset. Unfortunately, the *Brown* court seems to view business valuation in the matrimonial context differently than it would be perceived in an oppression case. It should be clear that while valuation of a minority share in a business is one thing, the business of apportioning that value in the context of "equitable distribution" is quite another. Tragically, it appears the *Brown* court mixed up these two issues substantially. It appears that the Appellate Division in some instances has substituted its own judgment for that which constitutes factual issues and is recasting factual issues as substantive legal issues. That is inapposite to what the Supreme Court ruled in the above *Balsamides* and *Lawson* cases.

~~In sum, *Balsamides* has cleared up~~ certain areas of dispute, and has also filtered into the divorce context on valuation matters involving close corporations. It has cast a definite shadow on valuation decisions, and it appears it may well have an impact on even minority valuations of even publicly traded shares. ■