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Balsamides' Long Reach in Appraisals Of Close-Corporation Split-ups

Oppressed shareholders are equitably protected by discounts, at the expense of wrongdoers
Under Balsamides, oppressed shareholders are equitably protected by discounts, at the expense of wrongdoers.

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Since the New Jersey Supreme Court decided *Balsamides v. Protameen*, 160 N.J. 352 (1999), along with its companion case, *Lawson Mardon Wheaton, Inc. v. Smith*, 160 N.J. 338 (1999) (dealing with minority oppression), the case has become a statewide, if not nationally recognized, seminal decision concerning business valuation and the applicability of minority and marketability discounts in oppressed shareholder cases.

In fact, over time, *Balsamides* has been further amplified and serves as the foundation of shareholder, partnership and limited liability dispute law in New Jersey and several other states. It incorporates key equitable and legal principles concerning minority shareholder oppression, and the concomitant rights and responsibilities that result in such high-pressure circumstances.

In *Balsamides*, 50 percent shareholders Emanuel Balsamides and Leonard Perle of Protameen Chemical, Inc., became embroiled in a dispute and deadlocked after Perle brought his sons into the business and decided they should have the same compensation as Balsamides' sons. This dispute for control and compensation became the fulcrum for oppression and a forced sale.

The trial court determined that Balsamides was an "oppressed shareholder" and was entitled to buy out Perle's interest in Protameen, but at a significantly discounted price.

There were several "firsts" in *Balsamides*: it was the first time a 50 percent shareholder was declared an "oppressed minority" and given protection under the Oppressed Minority Shareholder Statute, N.J.S.A. 14A:12-7, et seq.; it was the first time punitive damages were imposed under the statute to a 50 percent shareholder; it was the first time a "marketability discount" was applied to a 50 percent shareholder's interest; Balsamides was also awarded attorneys' fees at the appellate level; and it was determined that "fair value" was not equivalent of "fair market value," and constituted a "factual" and not a "legal" issue, not reviewable on appeal.

A central dispute concerned the appropriate use of a marketability discount in the forced sale of a close corporation. Such a discount adjusts for a lack of liquidity in one's interest in an entity for which there is no recognized market.

The Court also essentially applied the "marketability discount" to assure that equitably the wrongdoer, Perle, would not be rewarded for his oppressive conduct. Balsamides' expert proposed a 35 percent marketability discount, which the trial court accepted, but the Appellate Division reversed on that basis alone, claiming the discount resulted in too low a purchase price. The New Jersey Supreme Court reversed the appellate court and applied a "marketability discount." As the Court concluded:

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. Requiring Balsamides to pay an undiscounted price for Perle's stock penalizes Balsamides and rewards Perle. The statute does not allow the oppressor to harm his partner and the company and be rewarded with the right to buy out that partner at a discount. We do not want to afford a shareholder any incentive to oppress other shareholders.... The guiding principle we apply in this case and in *Lawson Mardon Wheaton* is that a marketability discount cannot be used unfairly by the controlling or oppressing shareholders to benefit themselves to the detriment of the minority or oppressed shareholders.

The New Jersey Supreme Court determined the trial judge was the fact-finder as to valuation, and ultimately ruled that valuation was inherently a factual, not legal, issue. The Court further determined that the Oppressed Minority Shareholder Statute was the appropriate method through which a forced sale was mandated, as opposed to contract law which does not require a forced sale.

Within New Jersey, the *Balsamides* decision has had a significant impact on lower court rulings with respect to a wide variety of corporate law issues in addition to those about valuation.

The first trial court decision to follow *Balsamides* was *Musto v. Vidas*, 333 N.J. Super. 52 (App. Div. 2000), which, like *Balsamides*, stressed that the equities of the case govern oppressed minority shareholder situations, and considered the equities in setting the "valuation date," which is critical to the valuation process. *Musto* further established that the court is not obligated to find that a defendant acted in bad faith in order to impose counsel fees under the statute.

The Oppressed Minority Shareholder Statute calls for the payment of "fair value" for an oppressed shareholder's/partner's/member's interest in a corporation, partnership or limited liability company. Oddly, the Legislature failed to define the term *fair value* in the legislative history. This has long caused significant confusion. However, it appears that the Legislature may have been thinking about *fair value* as the term is used in the accounting context. In that context, it is defined as a rational and unbiased estimate of the potential market price of a good, service or asset, which takes into account such objective factors to establish present value as opposed to historical cost.

Thus, "fair value" should not consider the historical cost or value, but should be established with a current or actual value. "Fair value" is thus distinguished from "fair market value," as it requires the assessment of a price that is both equitably and economically fair. Of course, the lack of definition opens up a debate and sometimes wide latitude for a trial court. However, the Supreme Court clearly imposed the use of "marketability" and "minority discounts" to equitably set fair value, as well as to punish the oppressor.

When oppressed shareholder cases arise, two types of discounts are generally considered. The first is a "minority discount," which adjusts the stock price due to lack of control over the business. The second is a "marketability discount," which adjusts for lack of liquidity in one's interest in an entity given the limited supply of potential buyers for stock in a closely held corporation. *Balsamides* dealt with a "marketability discount." In *Casey v. Brennan*, 344 N.J. Super. 83 (App. Div. 2001), *aff'd* 173 N.J. 177 (2002), the Appellate Division, following the reasoning of *Balsamides*, ruled that the "minority discount" like the "marketability discount" is reserved for extraordinary circumstances so as not to benefit the wrongdoer.

Three years after *Balsamides*, in *Brown v. Brown*, 348 N.J. Super. 466 (App. Div. 2002), the Appellate Division held, in the matrimonial context, that absent extraordinary circumstances for purposes of equitable distribution, a marketability discount should generally not be used.

The court so held because it determined, in the context of equitable distribution, that there is no actual transfer of the shares, and no likely sale of the business in the foreseeable future (except for circumstances where the spouses themselves are the co-shareholders). However, the *Brown* court appears to have mixed apples with oranges, confusing principles of "equitable distribution" with "fair value." Generally, interest in a corporation should be valued as any other divisible asset, and only after valuation of the corporate interest is established (just as any other asset) should equitable distribution principles be applied.

In more recent years, the influence of *Balsamides* in the New Jersey courts has extended beyond the valuation context. In *Pappas v. Coach House*, 2005 N.J. Super. LEXIS 800 (Ch. Div. June 17, 2005), the court cited *Balsamides* for the proposition that in exceptional cases the oppressed minority shareholder may buy out the majority, especially where there is a strong showing that the minority was instrumental in the corporation's viability.

In *Liu v. Star Pacific Corp.*, 2009 N.J. Super. LEXIS 3109 (App. Div. Dec 23, 2009), the court held that where a shareholder had fabricated his majority shareholder status and diverted corporate assets, the trial court was readily justified in awarding punitive damages in an oppressed minority case pursuant to *Balsamides*.

Most recently, the Appellate Division in *Moschillo v. Jovanov*, 2010 N.J. Super. LEXIS 3130 (App. Div. Dec. 29, 2010), reaffirmed the basic principle of *Balsamides* which underlies all of these disputes, i.e., that an oppressor should not be rewarded for his/her wrongdoing. In *Moschillo*, the Appellate Division ruled that if the majority shareholder engaged in wrongdoing, he should not be permitted to benefit by his own misconduct and buy out the plaintiff at a discount.

Several other states have adopted and relied on *Balsamides* when grappling with how to apply a marketability discount or minority discount in the context of shareholder valuation.

Balsamides also has been cited in about 15 law review articles. If there has been any criticism of the decision, certain of these journal articles have taken the Balsamides Court to task for using the marketability discount as a way to penalize the wrongdoer.

However, the law review articles evidence little of the practicality or knowledge of the *Balsamides* Court, which applied "marketability" and "minority" discounts to equitably protect the oppressed party at the expense of the wrongdoer. They fail to acknowledge that the separate remedy of punitive damages is available for that purpose, and indeed was used by the *Balsamides* Court.

Ultimately, *Balsamides* has stood the test of time and been adopted and referenced in many state and federal courts. It provides seminal guidance for applying "marketability" and "minority" discounts in the forced sale of close corporations, and is even cited in Internal Revenue Service regulations. *Balsamides* has cast a definite shadow in valuation decisions, and the equitable and legal characteristics that pervade valuation cases.
