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Focus on Dissenting Shareholder Appraisal Rights and Shareholder Oppression Litigation

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Thought Leadership

Insights

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Focus on Dissenting Shareholder Appraisal Rights and Shareholder Oppression Litigation
Editor for This Issue: Timothy J. Meinhart

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Forethoughts

This *Insights* issue focuses on shareholder litigation matters. More specifically, we focus on the valuation and forensic analysis issues related to statutory shareholder rights, dissenting shareholder appraisal rights, noncontrolling shareholder oppression claims, and shareholder rescissory damages claims.

Shareholder grievances may involve claims against a corporation, a corporate board of directors, a special committee of the board of directors, and/or the officers of a corporation. These grievances commonly include claims for breach of fiduciary duty, unfair and inequitable dividend policy, unjust enrichment, the receipt of less than fair consideration paid in a merger or acquisition, and/or dissipation of corporate assets.

In the last several years, the amount of shareholder litigation has increased significantly. Many of these disputes are resolved in court, which is usually a time-consuming and expensive process. Other disputes may be settled through monetary agreements, agreed-upon changes to corporate structure or governance, or other concessions.

In this *Insights* issue, we are extremely pleased to include discussions authored by prominent experts in the securities litigation field. These discussions will help the reader understand the complexities of the various legal and valuation issues involved. These topics range from a discussion of noteworthy developments in the areas of shareholder appraisal rights and shareholder oppression claims to best practices in avoiding intrafamily shareholder disputes.

Willamette Management Associates analysts provide business valuation and financial opinion services to boards of directors and business owners as well as forensic analysis and expert testimony services to the legal counsel involved in shareholder rights litigation.

About the Editor

Timothy J. Meinhart

Tim Meinhart is a managing director in the Chicago office of Willamette Management Associates. Tim specializes in the financial valuation of close corporations, close corporation fractional ownership interests, intangible assets (including intellectual property), general and limited partnership interests, limited liability company interests, restricted equity and debt securities, preferred stock, proprietorships, options and warrants, and fractional interests in real estate. In addition, Tim provides consulting services to closely held business owners and boards of directors and to their professional advisers in a financial planning and strategic advisory capacity.

Tim routinely provides valuation consulting and expert testimony services in connection with shareholder appraisal rights matters and economic damages claims. Tim has testified on these matters in several forums, including in the Delaware Court of Chancery where he testified in *In re: Appraisal of The Orchard Enterprises, Inc.*, and *Reis, et al. v. Hazelett Strip-Casting Corporation, et al.*

Tim has also prepared valuation and economic analyses for the following purposes: tax planning and compliance (ad valorem, income, gift, and estate), forensic analysis and dispute resolution, financial reporting, transaction planning (acquisition, divestiture, liquidation, and reorganization), fiduciary compliance, and management information and strategic planning.

Tim has also performed valuation or arm's-length royalty rate/transfer price analyses related to the following types of intangible assets: copyrights, customer contracts, customer lists and customer relationships, employment contracts, engineering drawings, going-concern value, goodwill, licenses, noncompete covenants, patent applications, patents, procedural manuals, trained and assembled workforces, trade names, trademarks, and training manuals and documentation.

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Tim is an accredited senior appraiser (ASA) of the American Society of Appraisers, accredited in business valuation. He is a past president of the Chicago chapter of the American Society of Appraisers, and he served on the Chicago chapter's executive board for the period of 2004 through 2009. He has been elected to the business valuation committee of the American Society of Appraisers, and he is the president of the Business Valuation Association of Chicago. Tim is also an associate member of the American Bar Association (ABA).

Tim has written extensively on the subject of security valuation and economic analysis. In addition, he is a contributing author to *The Handbook of Business Valuation and Intellectual Property Analysis*. He has spoken on economic analysis and business valuation issues to various professional groups and associations. Since 2011, Tim has served on the valuation committee of the editorial advisory board of the *Trusts & Estates* professional journal.

Best Practices

The Rise of Appraisal Litigation: Will the Fire Spread?

Eli Richlin, Esq., and Tony Rospert, Esq.

Appraisal actions allow shareholders who believe they will receive inadequate consideration in a merger transaction to dissent and petition the court to appraise the fair value of their shares. The Delaware courts have seen a sharp increase in shareholder rights appraisal litigation in recent years. This increase may be due to liberal standing requirements and the emergence of specialized hedge funds and activist investors that have learned how to make effective use of the appraisal remedy. This discussion (1) provides an overview of appraisal actions, (2) highlights several recent appraisal decisions in Delaware, (3) addresses potential reform efforts, and (4) analyzes prospects for future growth in appraisal actions in Delaware and in other jurisdictions.

Introduction

Appraisal litigation has emerged in recent years as the new "hot" area in litigation arising out of acquisitions. Indeed, a *Wall Street Journal* analysis found that a record 33 public company appraisal cases were filed in Delaware in 2014, with 20 more filed in the first four months of 2015.[1]

Dissenting shareholder appraisal rights cases have become the newest battleground between corporations and activist investors. This surge in dissenting shareholder appraisal cases is due primarily to an increase in the use of appraisal arbitrage by activist investors.

Appraisal arbitrage refers to hedge funds and other activist investors acquiring target shares after an announcement of a public company merger with the goal of seeking appraisal rights under state statutory schemes.

The appraisal process allows shareholders who are dissatisfied with the consideration offered by the acquirer to petition a court for an appraisal of their shares' "fair value." What makes this attractive to activist investors, particularly in an atmosphere of low interest rates, is that the "return" on a successful appraisal action may yield a higher court-determined price plus interest at a statutory rate. Given the higher interest rates in the appraisal statutes, investors can realize quick returns.

Critics complain that the increase in appraisal arbitrage may hinder otherwise constructive transactions and worry that buyers will offer less in anticipation of the capital they will lose when appraisal arbitrageurs strike. Proponents argue that appraisal arbitrageurs play an important role as specialists with the ability to hone in on deals and ensure that shareholders receive fair value.[2]

In this discussion, we describe appraisal actions and review recent trends, with a focus on Delaware—the epicenter for shareholder appraisal litigation. We also examine reasons why, despite the heightened focus on appraisal actions, the upswing in appraisal litigation in Delaware may not portend a similar tide of litigation in other jurisdictions that have enacted appraisal statutes.

Yet, even if the fire does not spread, the use of appraisal actions in Delaware shows no sign of abating any time soon.

Background and Overview of Appraisal Actions

The recent increase in appraisal litigation can be traced back to corporate law's infancy. Corporate codes historically required unanimous shareholder approval before any merger or other fundamental corporate change could be accomplished.[3]

> "... [C]ourts traditionally rely on complex valuation processes absent evidence of price negotiations or a competitive bidding process."

Requiring unanimous consent understandably proved unwieldy and incentivized holdouts. Legislatures responded by removing unanimity requirements from their corporate codes, with appraisal rights emerging as a different and more manageable way to protect opposing noncontrolling shareholders.[4]

For example, Delaware law today allows shareholders who believe they will receive inadequate consideration through a merger transaction to dissent from the merger and petition the court to appraise the fair value of their shares.[5] A shareholder will then receive a court-determined fair value rather than the consideration offered by the acquiring company.

In Delaware, unlike in other states where appraisal may be sought following a sale of assets or an amendment to the company's certificate of incorporation, appraisal is only available in a merger.[6] Appraisal actions are further limited to cash deals.[7]

The mechanics of an appraisal action require a shareholder to submit the question of value of his or her shares to a court. Appraisal actions are distinct from other shareholder actions in that neither party bears the burden of proving or defending wrongdoing; instead, both parties seek to demonstrate the fair value of the shares.[8]

The determination of fair value is the court's sole task. To determine fair value, a court evaluates the merger transaction and the fundamentals of the company's business to determine the present fair value of the company's stock. The shareholder takes the risk of the court setting a value *lower* than the price offered in the merger. This is because the court is not required to recognize the offer as a floor in the appraisal process.[9]

To support their claims in an appraisal hearing, parties commonly rely on valuation experts. And, each party's valuation expert advocates value based on the factors that lead to the highest (or lowest) price.[10]

This leaves the court in the position of refereeing a "battle of the experts" and deciding which expert's analysis more accurately encompasses fair value. Appraisal actions have come under criticism because they require courts to perform complex financial analyses, an endeavor that extends well beyond core legal expertise.[11]

The only guidance Delaware law provides regarding the valuation process is that all relevant factors should be considered; these might include the historic trading price, bidding history during the sale process, deficiencies in the company's control or operations, and the industry's competitive landscape.[12]

A court may not consider value expected from the merger that is not yet ascertainable.[13]

Some recent decisions have used the negotiated merger price as the proper measure of fair value where the company embarked upon a competitive and arm's-length merger process, though courts traditionally rely on complex valuation processes absent evidence of price negotiations or a competitive bidding process.[14]

Highlights of Recent Delaware Appraisal Actions

The increase in appraisal litigation has been fueled by a number of notable recoveries.[15] For example, appraisal litigation proved worthwhile in the Energy Services Group merger, where shareholders were awarded $15.9 million above the offering price ($42,165,920 in total), representing a $12 per share increase from the $19.95 offering price.[16]

In reaching his decision, Chancellor Andre Bouchard relied on management projections that formed the basis for the merger price and made certain other conclusions regarding a discounted cash flow analysis and relevant tax consequences that resulted in a fair value award well above the merger price.

By contrast, Vice Chancellor Donald Parsons' recent decision in another appraisal action related to the Cypress-Ramtron merger limited a shareholder's recovery to the merger price.[17]

There, he rejected management projections that appeared litigation-driven and not in accordance with the reality of the business and instead placed great weight on a "proper transactional process."

In particular, Parsons cited Ramtron's rejection of initial merger offers and efforts to identify other buyers, finding that these actions supported the ultimate merger price as a reflection of fair market value for valuation purposes.

Appraisal Arbitrage Controversy and Proposed Amendments to Delaware's Appraisal Statute

Appraisal arbitrage has been credited—and criticized—as a major cause of the increase in appraisal

litigation. In this increasingly popular strategy, shareholder activists and hedge funds acquire a target company's shares *after* a merger announcement, oppose the deal, and then proceed to seek appraisal.[18]

While the appraisal remedy has been criticized as "cumbersome," a "complicated maze," "complicated and expensive," with a "Byzantine procedure for asserting one's appraisal rights,"[19] increasingly sophisticated petitioners—specialized activist hedge funds who have learned how to effectively navigate the appraisal process by bringing multiple appraisal proceedings and have been rewarded with notable recoveries—have overcome these systemic obstacles.[20]

Delaware's liberal interpretation of standing requirements has enabled this type of arbitrage. This is because an appraisal action is available to plaintiffs who purchase stock in a company after the announcement of the merger, so long as they (1) make the proper demand requirements, (2) do not vote in favor of the merger or otherwise consent to it, and (3) hold the shares continuously through the effective date.[21]

The investors must forego the merger consideration and prove enough shares were not voted in favor of the merger to cover the number of shares seeking appraisal. But, if they meet those requirements, the plaintiffs have appraisal standing even for shares acquired after the record date.[22]

Critics also blame another Delaware statutory feature for the rise in appraisal arbitrage: Delaware law allows appraisal awards to accrue and compound quarterly interest from the effective time of the merger through the appraisal judgment at a rate 5 percent over the Federal Reserve discount rate.[23]

Interest compounding applies to the entire appraisal award. By extension, even if a court appraises fair value at a price lower than the deal consideration, the plaintiff still receives protection by virtue of the interest payments. Critics have raised concerns that these guaranteed interest payments provide another incentive for shareholders to lodge appraisal suits.[24]

In response to these considerations, the Council of the Corporation Law Section of the Delaware State Bar Association has proposed two amendments to the appraisal statute that address concerns about nuisance litigation in connection with the flux of appraisal arbitrage.

The first proposed amendment would (1) align Delaware law with minimum ownership standards already employed by other states and (2) require that all shareholders in an appraisal action involving a public company deal collectively hold at least 1 percent of the total shares entitled to appraisal or $1 million worth of the shares measured in deal value.[25]

As in other states, the amendment would set a floor of required appraisal petitions before the remedy becomes available.[26]

The second proposed amendment would address supposed nuisance litigation by allowing the surviving company to pay each party seeking appraisal an amount of cash at the start of the action.[27] Interest would only accrue on the difference between the cash payment and the ultimate appraisal award.[28]

This proposed amendment is meant to address the guaranteed compound interest award described above and remove any incentive the interest award alone might provide in encouraging otherwise meritless suits.

In sum, the amendments do not affect standing requirements and thus do not directly address the *modus operandi* of appraisal arbitrageur specialized hedge funds. Still, the amendments likely will constrain nuisance claims by minimizing unsubstantiated claims and reducing the economic enticement that accrued interest provides.

Constraining Appraisal Litigation Growth Elsewhere

Despite the increase in appraisal litigation and the heightened focus by specialized hedge funds and activist investors who have reaped rewards by playing the appraisal arbitrage game, there are several factors that may limit growth in appraisal litigation in other jurisdictions.

The most important of these relates to the interplay between the lower comparative market capitalization of non-Delaware mergers and the correspondingly reduced economic incentive and ability for appraisal arbitrageurs to get involved.

At the outset, it is important to recognize that the appraisal remedy is not limited to Delaware law. That high-profile appraisal claims are commonly brought in the Delaware Court of Chancery owes more to the state's status as the incorporation site of many prominent companies.[29]

Yet, no fewer than 45 states and the District of Columbia have codified "dissenters' rights" statutes that allow dissenting shareholders to seek fair value for their shares.[30]

Still, these statutes see less use than Delaware's. As examples, the New York appraisal remedy is contained in New York Business Corporation Law Sections 623 and 910. Section 623 has been cited a handful of times since 2014, while Section 910 has not been cited by any court since 2012.

The Ohio dissenting shareholder statute, Ohio Revised Code Section 1701.85, has not been cited since 2013. And, the Georgia statute, Official Code of Georgia Section 14-2-1302, has not been cited since 2007.

Moreover, many of the cases brought under other states' statutes involve smaller privately held corporations, rather than the large public corporations involved in Delaware appraisal actions. Hedge funds might not have any means for purchasing shares of private corporations, and even a small publicly held corporation may present a less attractive target to appraisal arbitrageurs. This is because the opportunity to achieve a significant return through appraisal arbitrage is lower.

In addition, the availability of key elements that enable and encourage hedge funds to jump into merger transactions and bring Delaware claims post-announcement—including the liberal standing requirements allowed by the Delaware courts and the generous guaranteed interest for appraisal awards—is less certain in other jurisdictions due to more limited statutory language, less developed jurisprudence, or both.

These limitations operate as a further brake on the spread of appraisal litigation and the arbitrage game into other jurisdictions. In light of these dynamics, among others, we have not observed marked growth in the use of state appraisal statutes outside of Delaware to date and do not anticipate this pattern will change in the immediate future.

Future of Appraisal Litigation

Appraisal litigation remains a hot issue in the Delaware courts. It is anticipated, absent legislative reform, that activist investors will continue to use the liberal standing requirements and potential high interest awards to challenge public company mergers using the Delaware appraisal statute as their weapon of choice.

What remains to be seen is whether the notable recoveries in the Delaware courts will encourage activist investors to pursue appraisal actions in other jurisdictions.

It is not anticipated that appraisal litigation will spread to other states because the statutory schemes in other jurisdictions are not uniform in scope and application, among other reasons.[31]

Nonetheless, because most jurisdictions have appraisal statutes, motivated parties may test the appraisal litigation waters following the announcement of a public company merger or going-private transaction.

Notes:

1. Liz Hoffman, "Wall Street Law Firms Challenge Hedge-Fund Deal Tactic," *Wall Street Journal*, (April 6, 2015).
2. Charles Korsmo and Minor Myers, "Shareholder Litigation That Works," *New York Times* (April 16, 2015).
3. See Charles Korsmo and Minor Myers, "The Structure of Stockholder Litigation: When Do the Merits Matter?" 75 *Ohio State Law Journal* 829 (2014).
4. *Id.*; 8 Del. C. § 262(b).
5. 8 Del. C. § 262.
6. *Id.*
7. *Id.*
8. See In re Appraisal of Ancestry.com, Inc., C.A. No. 8173-VCG, 2015 Del. Ch. LEXIS 21, at *3 (Del. Ch. Jan. 30, 2015).
9. See Gearreald v. Just Care, Inc., C.A. No. 5233-VCP, 2012 Del. Ch. LEXIS 91 (Del. Ch. Apr. 30, 2012) (court found that fair value of company for appraisal purposes was $6 million less than merger price); Jeremy D. Anderson and José

P. Sierra, "Unlocking Intrinsic Value Through Appraisal Rights," *Law360*, Sept. 10, 2013 (in 8 of 45 appraisal cases reviewed, appraisal of fair value by the court was less than the merger price).

10. See Merlin Partners LP v. AutoInfo Inc., C.A. No. 8509-VCN, 2015 Del. Ch. LEXIS 128 (Del. Ch. Apr. 30, 2015).
11. See Ancestry.com, *supra* n.8, 2015 Del. Ch. LEXIS 21, at *2 (noting the "difficulties, if not outright incongruities, of a law-trained judge determining fair value of a company in light of an auction sale, aided by experts offering wildly different opinions on value").
12. AutoInfo, *supra* n.10.
13. *Id.*; 8 Del. C. § 262(h) (providing that determination of fair value be "exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation").
14. Compare AutoInfo, *supra* n.10 (using merger price as fair value) and Ancestry.com, *supra* n.8 (same) with Laidler v. Hesco Bastion Envtl., Inc., C.A. No. 7561-VCG, 2014 Del. Ch. LEXIS 75 (Del. Ch. May 12, 2014) (using direct capitalization of cash flow method).
15. See Karlee Weinmann, "Chancery Dings Appraisals, But Deal Makers Still Vulnerable," *Law360*, Feb. 2, 2015; Karlee Weinmann, "M&A Cases to Watch in 2015," *Law360*, Jan. 2, 2015.
16. Owen v. Cannon, C.A. No. 8860-CB, 2015 Del. Ch. LEXIS 165 (Del. Ch. June 17, 2015); Amaris Elliott-Engel, "Appraisal Gains Major Shareholder $16M in Value After Merger," *Delaware Business Court Insider*, June 24, 2015.
17. LongPath Capital, LLC v. Ramtron Int'l Corp., C.A. No. 8094-VCP, 2015 Del. Ch. LEXIS 177 (Del. Ch. June 30, 2015).
18. The hedge fund Merion Capital LP pursued this strategy in the Ancestry.com and BMC Software buyouts. Merion Capital LP v. BMC Software, Inc., C.A. No. 8900-VCG, 2015 Del. Ch. LEXIS 3 (Del. Ch. Jan. 5, 2015); In re Appraisal of Ancestry.com, Inc., C.A. No. 8173-VCG, 2015 Del. Ch. LEXIS 2 (Del. Ch. Jan. 5, 2015).
19. See Minor Myers and Charles Korsmo, "Appraisal Arbitrage and the Future of Public Company M&A" 92 *Washington University Law Review* __ (forthcoming 2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2424935.
20. *Id.*
21. See BMC Software, supra n.18; In re Appraisal of Transkaryotic Therapies, Inc., C.A. No. 1554-CC, 2007 Del. Ch. LEXIS 57 (Del. Ch. May 2, 2007).
22. See BMC Software, Inc., *supra* n.18.
23. 8 Del. C. § 262(h)-(i).
24. Hoffman, "Wall Street Law Firms Challenge Hedge-Fund Deal Tactic," *supra* n.1. ("Also encouraging funds to mount the campaigns: They are guaranteed interest equivalent to 5.75% annually on the value of their stakes as the appraisal review takes place. That amount, established during a period of higher interest rates, is especially attractive amid today's low yields.")
25. Steven Davidoff Solomon, "A Three-Pronged Front to Limit Shareholder Litigation," *New York Times* (April 2, 2015).
26. *Id.*
27. *Id.* Note that Vice Chancellor Sam Glasscock discussed this approach in Huff Fund Inv. P'ship v. CKx, Inc., but declined to adopt it given the lack of statutory authorization. C.A. No. 6844-VCG, 2014 Del. Ch. LEXIS 18 (Del. Ch. Feb. 12, 2014), *aff'd*, No. 348, 2014, 2015 Del. LEXIS 77 (Del. Feb. 12, 2015).
28. Solomon, "A Three-Pronged Front to Limit Shareholder Litigation," *supra* n.25.
29. Delaware's appraisal statute permits "[a]ny stockholder of a corporation of this State" to bring appraisal actions in "the Court of Chancery." 8 Del. C. § 262(a).
30. See Pueblo Bancorporation v. Lindoe, Inc., 63 P.3d 353, 364-369 (Colo. 2003) (surveying state laws).
31. Note that many states have modeled their dissenters' rights statutes off of the Model Business Corporation Act (MBCA); of these states, "five have adopted the definition of 'fair value' found in the 1999 amendments to the MBCA and another twenty-seven . . . have a definition that is identical or nearly identical to that found in the 1984 MBCA." Pueblo Bancorporation, *supra* n.30, at 365.

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The authors gratefully acknowledge the assistance of David Hooker and Marilyn Eble in preparing this discussion.

Dissenting Shareholder Appraisal Rights and Shareholder Oppression Claims: Similarities and Differences in Securities Valuation

Lisa H. Tran and Irina V. Vrublevskaya

Over the past three decades, the number of both dissenting shareholder appraisal rights claims and shareholder oppression claims increased significantly. This increase has created a demand for forensic-related business and security valuation services. Valuation analysts are not legal counsel, of course. However, valuation analysts who practice in this area should be generally familiar with both the economic and the legal differences between dissenting shareholder appraisal rights issues and shareholder oppression issues. While taking specific legal instruction from legal counsel, valuation analysts should have a general familiarity with the professional guidance provided by the American Bar Association, the American Law Institute, state statutes, and relevant judicial precedent in order to perform forensic-related valuation services.

Introduction

Litigation involving dissenting shareholder appraisal rights claims and shareholder oppression claims was relatively infrequent until the 1983 *Weinberger v. UOP* decision in the State of Delaware.[1]

Since that judicial decision was handed down, the volume of litigation has increased significantly with respect to both shareholder appraisal rights claims and shareholder oppression claims.

To better provide forensic valuation services, the valuation analyst should understand the evolution of dissenting shareholder appraisal rights and shareholder oppression issues.

This understanding may help the valuation analyst discern the economic elements that impact the valuation of a company in a dissenting shareholder appraisal rights case or in a shareholder oppression case.

In addition, the valuation analyst should seek—and rely on—specific instruction from legal counsel. Legal counsel should instruct the valuation analyst with regard to any of the legal differences between dissenting shareholder claims and shareholder oppression claims.

Dissenting Shareholder Appraisal Rights Actions

A dissenting shareholder who is exercising a statutory or contractual right to dissent from a corporate action may have the legal right to seek an appraisal of his/her shares in the company. Dissenting shareholders typically have statutory appraisal rights in circumstances such as a merger, the sale of substantially all of the corporate assets, recapitalization, amendments to articles of incorporation that creates fractional shares, or other major changes to the nature of their investment in the corporation.

In a statutory dissenting shareholder appraisal rights action, the exclusive shareholder remedy is cash.

History and Overview

According to the common law of most states in the early 19th century, the implementation of any extraordinary corporate decision required the unanimous vote of the corporation shareholders. Accordingly, a noncontrolling shareholder could use this law to paralyze the decision-making process of the subject corporation.

The onset of the industrial revolution and the development of the transcontinental railroads convinced both the courts and the corporations that the unanimity vote requirement was an inefficient process to support the rapid growth in the increasingly complex economy.

In 1892, the Illinois Supreme Court ruled in *Wheeler v. Pullman Iron & Steel Co.*[2] that corporate policy should be decided by the majority of the shareholders. That is, corporate policy should not require the unanimous vote of all shareholders. After the *Wheeler* decision, more courts began to adopt this so-called majority rule.

As a result of the shift to the so-called majority rule, noncontrolling shareholders who disagreed with the decisions of the controlling shareholders were powerless to challenge such actions. However, such dissenting shareholders could not exit the corporation if the shares were not publicly traded. This situation led to the development of statutory appraisal rights for such dissenting noncontrolling shareholders.

Before the development of the shareholder appraisal rights statutes, dissenting noncontrolling shareholders had to petition the courts to stop a corporation from pursing a course of action until the noncontrolling shareholders received the fair value (in cash) of their shares. These injunctive procedures were expensive, lengthy, and disruptive to the corporate business. As a result, state legislatures implemented shareholder rights appraisal statutes that allowed noncontrolling shareholders to dissent from specified corporate transactions.

In 1927, the Uniform Business Corporation Act ("the Act") was introduced by the National Conference of the Commissioners for Uniform State Laws. The Act was introduced to provide legislation that would bring clarity and uniformity to certain areas of the law.

The Act was adopted by only Louisiana, Washington, and Kentucky. This was because most states wanted the flexibility to make their own interpretation of the law.

However, during the first half of the 20th century, nearly all states adopted some form of a shareholder appraisal rights statute. Table 1 indicates the year when each state first adopted a dissenting shareholder appraisal rights statute.

Today, the majority of dissenting shareholder appraisal rights cases are a result of a controlling shareholder squeezing out a noncontrolling shareholder for cash. Although the specific procedures may vary from state to state, the events that result in a dissenting shareholder rights action follow a specific order.

First, a corporation's board of directors is required to give notice of a contemplated corporate action from which noncontrolling shareholders may dissent. Any dissenters then decline the consideration and demand payment for their shares in a notice to the board of directors before the corporate action is implemented.

This demand initiates the appraisal rights case in which the dissenters lose all rights to the corporation, except the right to receive payment for the fair value of their corporate shares.

Table 1
Date When Each State First Passed a Dissenting Shareholder Appraisal Rights Statute

New York – 1890	Ohio – 1906	Louisiana – 1928
Maine – 1891	Tennessee – 1907	Idaho – 1929
Kentucky – 1893	Maryland – 1908	Indiana – 1929
New Jersey – 1896	Vermont – 1915	California – 1931
Delaware – 1899	Illinois – 1919	District of Columbia – 1931
Connecticut – 1901	New Hampshire – 1919	Michigan – 1931
Pennsylvania – 1901	Rhode Island – 1920	Washington – 1933
Alabama – 1903	Arkansas – 1925	Hawaii – 1937
Massachusetts – 1903	Florida – 1925	Georgia – 1938
Nevada – 1903	North Carolina – 1925	Arizona – 1939
Virginia – 1903	South Carolina – 1925	Kansas – 1939
Montana – 1905	Minnesota – 1927	
New Mexico – 1905	Oregon – 1927	

Shareholder Oppression Actions

Shareholder oppression actions typically are a result of closely held corporation shareholders (1) who claim to have been treated unfairly or prejudicially by the controlling shareholder(s) and (2) who seek dissolution of the corporation or a buyout of their shares.

The allegedly oppressed shareholders have to prove that the controlling shareholder(s) purposely excluded them from their proper share of the benefits of corporate ownership.

History and Overview

The need for a legal resolution to shareholder oppression claims evolved in the same manner as the evolution of a remedy for dissenting shareholder appraisal rights claims. That is, both remedies resulted from the move to majority rule, which potentially could harm or ignore the interests of the noncontrolling shareholders.

Like appraisal rights actions, shareholder oppression actions are primarily based on state statutes. For example, Illinois was the first state to recognize oppression as a trigger for the dissolution of a corporation in the 1933 Illinois Business Corporation Act. In 1953, the American Bar Association (ABA) incorporated the Illinois law into the Model Business Corporation Act's dissolution statute.

As shareholder oppression claims became more widely recognized, the courts had to define shareholder oppression and had to determine if such oppression had actually occurred.

In 1957, an Illinois court defined shareholder oppression in *Central Standard Life Insurance*[3] to include "conduct by the majority that breaches fiduciary duty, denies the minority shareholder his or her reasonable expectations in acquiring shares and entering into a shareholder agreement, or is burdensome, harsh, and wrongful to minority shareholder interests."[4] Shareholder oppression claims are different from shareholder appraisal rights claims in several respects. For example, shareholder oppression is generally more personal, and dissenting shareholder appraisal rights claims are the result of a financial decision by a corporation.

Shareholder oppression often involves the loss of employment, the exclusion of a shareholder who founded and assisted in the growth of the corporation, or a significant disagreement between close corporation family owners or business partners.

One similarity between dissenting shareholder rights claims and shareholder oppression claims is the application of the fair value standard of value by most states. Many courts agree that fair value has the same meaning in the context of shareholder oppression claims and in the context of dissenting shareholder rights claims. In fact, many shareholder oppression cases and dissenting shareholder rights cases cite each other's guidelines on various business valuation issues.

Initially, dissolution served as the legal remedy for shareholder oppression. This was because shareholder oppression statutes are part of corporate dissolution statutes. Certain behavioral conduct, such as corporate mismanagement or fraud, would be the basis to request the judicial dissolution of a corporation. However, the liquidation of a corporation is an extreme remedy as it affects corporate employees, suppliers, and customers.

As a result, some states began to allow a buyout provision for the shares of the oppressed shareholders. For example, California was the first state to incorporate a buyout provision in its statutes in 1941.

In 1973, in *Baker v. Commercial Body Builders, Inc.*,[5] the Oregon Supreme Court ruled that shareholder oppression behavior consisting of a "squeeze out," or "freeze out" in a closely held company, may use (1) dissolution as a remedy or (2) an alternative remedy such as a buyout.

Typically, shareholder freeze-out behavior includes the refusal to declare dividends, the termination of a noncontrolling shareholder's employment, and/or the reduction of corporate earnings due to excessive executive/shareholder compensation.

After the above-mentioned landmark Oregon decision, many states began to allow the use of shareholder buyout as an alternative remedy for shareholder oppression. Today, most states offer a buyout option in shareholder oppression cases.

The seven states that currently do not allow the buyout option include Arkansas, Colorado, Kentucky, New Mexico, Pennsylvania, Tennessee, and Washington. The following nine states currently have no statute allowing dissolution due to shareholder oppression: Delaware, Indiana, Kansas, Louisiana, Massachusetts, Nevada, Ohio, Oklahoma, and Texas.

In response to a shareholder oppression claim, a corporation may elect the buyout option to avoid judicial proceedings and any equitable adjustments. If the court discovers that acts of shareholder oppression did occur, then the corporation will ultimately pay fair value for the shares of the oppressed shareholders, plus any equitable adjustments that the court deems necessary.

Corporate Valuation in Shareholder Disputes

The Fair Value Standard

Both dissenting shareholder appraisal rights cases and shareholder oppression cases are governed by state law, which includes state corporation statutes. In dissenting shareholder and shareholder oppression corporate stock valuations, the state courts often allow fair value as the standard of value to estimate the value of the noncontrolling shareholder shares.

The Delaware appraisal statute mandates fair value of the corporation as a going concern as the measure of value. The statute also allows the same fair value standard in shareholder oppression and shareholder appraisal rights actions to determine noncontrolling shareholder share value.

Fair value is the standard of value for certain shareholder appraisal rights actions in 47 states and the District of Columbia. However, there are differing statutory and judicial interpretations of the meaning and measurement of the term “fair value.”

The Delaware Supreme Court clarified the meaning of fair value in that state in 1950, defining it as the value that had been taken from the dissenting shareholder:

> The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which had been taken from him, viz., his proportionate interest in a going concern. By value of the stockholder’s proportionate interest in the corporate enterprise is meant the true intrinsic value of his stock which has been taken by the merger.[6]

This judicial concept has been cited in numerous shareholder appraisal rights cases and shareholder oppression cases. This judicial concept was further expanded in recent years, identifying “what has been taken from the shareholder” as the pro rata share of the value of the company as a whole in most jurisdictions.

The reasoning behind the above-listed definition appears to be that the noncontrolling shareholder should not receive a lesser price for the shares because he/she does not share in the exercise of the control of the company. Doing so would impose a penalty for lack of control and unfairly enrich the controlling shareholders who may gain from the shareholder appraisal rights process by cashing out a dissenting shareholder.

When the noncontrolling shareholder is given a pro rata business enterprise value, the controlling shareholder cannot benefit disproportionately from forcing out the noncontrolling shareholder at a discounted price. As a result, neither a discount for lack of control nor a discount for lack of marketability is applicable in the Delaware definition of fair value.

“Fair value is the standard of value for certain shareholder appraisal rights actions in 47 states and the District of Columbia.”

The ABA, the American Law Institute (ALI), and Delaware appraisal statutes have all greatly influenced the development of the judicial interpretation of the fair value standard of value. Fair value is defined in the ABA Revised Model Business Corporation Act (RMBCA) and in the ALI Principles of Corporate Governance.

The RMBCA defines fair value as “the value of 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 would be inequitable.”[7] Currently, 21 states effectively use this definition of fair value.

Six states use the ALI concept of fair value as “the value of the eligible holder’s proportionate interest in the corporation, without any discount for minority status or, absent extraordinary circumstances, lack of marketability.”[8]

Three states, Louisiana, Ohio, and California, do not explicitly use the phrase “fair value” for dissenting shareholder appraisal rights matters. Louisiana and Ohio apply a fair cash value standard of value, but with different meanings. California applies a fair market value standard of value in dissenting shareholder rights matters, but not in shareholder oppression cases.

Using the fair value standard as opposed to the fair market value standard,[9] or third-party sale value,[10] strikes a balance between the dangers of shareholder oppression valuation—awarding a windfall to an opportunistic controlling shareholder who forced out noncontrolling shareholders or incentivizing litigation by noncontrolling shareholders attempting to capture value from controlling shareholders whose abilities have resulted in increased value.

In states where there is no specific shareholder oppression statute, the courts can act under their own equitable authority. For example, Delaware does not have a shareholder oppression statute.

If the Delaware court believes there is a conflict of interest in the actions of the majority shareholder, or oppressive corporate behavior has occurred, it may allow a breach of fiduciary duty "entire fairness"[11] action to be filed. If the case is designated as a fairness case, the Delaware court generally will use the same standard of value it uses in dissenting shareholder appraisal rights cases (i.e., fair value) to determine the noncontrolling share value.

Judicial interpretations and statutes in many states reject lack of control or lack of marketability pricing discounts in the determination of fair value. However, a few states still allow pricing discounts by precedent, at a court's discretion, or in special circumstances. Further, price premiums in corporate value that result from synergies accomplished by the transactions are also excluded from the determination of fair value in most shareholder appraisal rights statutes.

In fair value considerations, the courts often give significant weight to a stock price that was negotiated in an arm's-length transaction. The courts generally believe that if the controlling shareholders, who have the greatest insight into the value of the company, sold their share to a third-party buyer at the same price paid to the remaining shareholders, then the price received by the remaining shareholders may be fair.

However, because of synergies and the buyer's ability to change the corporate operations, or the financial structure of the company, fair value may be less than the value received in an arm's-length third-party transaction.[12] The courts have sometimes awarded dissenting shareholders amounts that were lower than the arm's-length transaction price. This is because the price may have included synergies and/or an acquisition price premium.

For example, in *Huff Fund v. CKx, Inc.*,[13] the company argued that the merger price should be lowered because it contained synergistic elements of value, and, specifically, cost savings identified prior to the merger that it hoped to realize by converting the subject company from a publicly held corporation to a private company. The Delaware Chancery Court did not rule on whether cost savings may represent excludable synergies. Instead, the court found no evidence that the acquirer arrived at its bid based on cost savings that the subject company may not have realized.

Additionally, in the *CKx* case, the petitioner claimed an upward price adjustment to account for the value resulting from the post-merger acquisition and unexploited revenue opportunities. The petitioner claimed these opportunities were part of the company's operating reality at the time of the merger but their value was not captured in the merger price.

In the *CKx* matter, the court ruled that since a market-derived stock price was the valuation method used, the issue was whether market participants were aware of the opportunities the acquirer and the company identified and reflected in the merger price. The court concluded that what information was available to the acquirer generally was also available to the market and declined to make any adjustments to the merger price.

A majority of states use all or part of the RMBCA definition of fair value, which involves several components. The valuation analyst needs to understand the requirements of the definition and each component separately.

The valuation analyst should consult with legal counsel for guidance before undertaking such a value assessment. This is because of the diversity among the states in their definition of fair value and the complexity of each state's statutes.

Further, although certain elements of valuation, such as the valuation date and the application of valuation discounts and premiums may be specified in the state statutes, the RMBCA, and the ALI, the valuation analyst should determine (1) the type of economic enterprise to be valued, (2) the context in which the valuation arises, and (3) the best methods appropriate to perform the valuation analysis.

Valuation Approaches and Methods

Neither the RMBCA nor the ALI defines any specific valuation methodology to estimate fair value for dissenting shareholder rights or shareholder oppression purposes. According to the RMBCA, the value of shares should be determined "using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal, and without discounting for lack of marketability or minority status except, if appropriate for amendments to the certificate of incorporation."[14]

Currently, 11 jurisdictions follow this definition for dissenting shareholder appraisal rights actions. Other states, including Delaware, developed their own definitions of fair value, or applied different standards of value in their statutes.

According to the ALI, "fair value should be determined using the customary valuation concepts and techniques generally employed in the relevant securities and financial markets for similar businesses in the context of the transaction giving rise to appraisal."[15]

As a result of numerous fair value cases, a considerable body of law has developed valuation methods. One such judicial method (that most observers believe to be obsolete) is the so-called Delaware

block method. This method weights a company's (1) investment value based on earnings and dividends, (2) market value typically based on public trading prices or guideline publicly traded company or transaction information, and (3) asset value, which is typically net asset value based on a current value of the underlying assets. These values are estimated and then assigned a weight to estimate the fair value of the noncontrolling shares.

In the 1983 *Weinberger*[16] decision, the Delaware Supreme Court declared that corporate value could be determined using alternative methods rather than just relying on the so-called block method. Therefore, this method is rarely used today in Delaware or elsewhere.

As a result of the *Weinberger* decision, alternative generally accepted business valuation approaches, methods, and procedures are used today to establish the fair value of the noncontrolling shares.

The Delaware block method relies on historical information, while many courts now prefer forward-looking valuation approaches. One income approach valuation method is the discounted cash flow method. This method is often used in dissenting shareholder appraisal rights cases.

Further, the appropriate valuation method is different in every case because corporations have different assets. No single valuation approach or valuation method can cover all industries. As such, flexibility in valuation is necessary to allow the valuation analyst and the courts to use their best judgment to seek equitable outcomes.

The business valuation approaches and methods that have been considered by the courts in dissenting shareholder rights and shareholder oppression cases include the following:

1. The income approach discounted cash flow method, which is widely used to estimate fair value, particularly in Delaware
2. The income approach direct capitalization method, which is often used to estimate fair value when long-term financial projections are not available;
3. The market approach guideline methods, including the comparison to guideline publicly traded companies and the comparison to guideline merger and acquisition transactions
4. The asset-based approach adjusted net asset value method or the asset accumulation method, which consider the going-concern value of the entity's assets (both tangible and intangible) less the current value of the entity's liabilities (both recorded and contingent)

The courts often consider more than one valuation approach and valuation method. According to the RMBCA, any appreciation or depreciation in anticipation of the corporate action should be excluded from the valuation analysis.

Similarly, in Delaware, fair value excludes "any element of value arising from the accomplishment, or expectation of the merger or consolidation,"[17] which requires the valuation analyst to value the company as if the corporate action had not taken place.

Valuation Date

The valuation date is one component of dissenting shareholder appraisal rights and shareholder oppression valuations. The valuation date can affect the ultimate fair value conclusion.

The RMBCA definition of fair value suggests that the court should set a valuation date immediately prior to the corporate action from which the shareholder dissents. A majority of states follow the RMBCA example. Such statutes state that the valuation should reflect the company value on the day before the corporate action occurred or was voted on. This concept is often used because the shareholder should not suffer or benefit from the effects of the transaction from which he/she dissents.

State statutes often instruct the courts as to the appropriate valuation date in shareholder appraisal rights cases. The valuation date in most states is defined as the day of, or the day before, the corporate action from which the shareholder dissents. Some states—such as Maryland and New York—define the valuation date as the day of, or the day before, the shareholder vote.

For example, in *Ritchie v. Rupe*,[18] the Texas Court of Appeals affirmed the use of the date of the company's last audited financial statements prior to the lawsuit as the valuation date. This is because there was no material change in share value between (1) the date of the oppression and (2) the date of the last audited financial statement.

Despite the fact that the date of the corporate action is generally the valuation date in shareholder appraisal rights cases, all information that is known or knowable as of the valuation date should generally be considered.

In a few cases, the courts considered events that occurred after the valuation date—but only as a "sanity check" in the valuation that was prepared based on valuation date information.

For shareholder oppression cases, the determination of fair value may be affected by the choice of the valuation date. The valuation date may be important to the relevant parties because

the company value can be affected by internal and external factors that can change in a short period of time. Thus, the choice of the valuation date can affect the ultimate fair value conclusion.

There are three types of valuation dates that may be considered. In many fair value determinations, the valuation date used is the date of filing or the preceding date. This date embodies the notion that the noncontrolling shareholder kept his/her status in the company as long as he/she chose to do so before being compelled to exit as a result of oppressive corporate behavior.

The second valuation date that may be considered is the date of oppression, which may be difficult to determine since oppressive corporate conduct typically occurs not on a single date but over a period of time. As such, the court may have to assess when the most severe acts of shareholder oppression occurred to select a valuation date.

The third valuation date that may be considered is a post-filing date, such as the trial date, judgment date, or the date the buyback order was issued. This valuation date may be inappropriate because the parties' actions may be influenced by the litigation.

The selection of the valuation date may vary depending on whether election is permitted in the state in which the shareholder oppression occurred. When the company or controlling shareholder is permitted to elect to buy out the dissenting shareholders, the date of filing is a reasonable valuation date. This is because an election often occurs before a court has found shareholder oppression and thus, the election statutes create a no-fault procedure.

For nonelection cases, the date of shareholder oppression may be reasonable valuation date. This is because it can be argued that adverse changes in company value after the oppressive corporate act should not be borne by the oppressed shareholder. However, the use of the filing date also may be justified to allow an oppressed shareholder the ability to benefit from increases in company value.

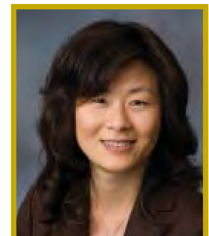
Conclusion

Litigation involving dissenting shareholder appraisal rights claims and shareholder oppression claims has increased over time. This increase causes demand for valuation services to estimate the noncontrolling shareholder share value.

To better provide forensic valuation services, the valuation analyst should understand the differences between dissenting shareholder appraisal rights issues and shareholder oppression rights issues. The valuation analyst should seek instruction from legal counsel regarding the legal elements that would affect the valuation of a company in such cases.

Notes:

1. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).
2. Wheeler v. Pullman Iron & Steel Co., 32 N.E. 420, 143 Ill. 197 (Ill. 1892).
3. Central Standard Life Insurance v. Davis, 141 N.E.2d 45 (Ill. 1957).
4. Chapter 3, "Fair Value in Shareholder Dissention and Oppression" in Jay E. Fishman, Shannon P. Pratt, and William J. Morrison, *Standards of Value: Theory and Applications*, 2d ed. (New York: John Wiley & Sons, 2013), 107.
5. Baker v. Commercial Body Builders, Inc., 507 P.2d 387 (Ore. 1973).
6. Tri-Continental v. Battye, 74 A.2d 71, 72 (Del. 1950).
7. Chapter 3 in Fishman, Pratt, and Morrison, *Standards of Value*, 122.
8. Ibid., 123.
9. In tax cases, the fair market value of minority shares may include significant discounts for lack of control and lack of marketability.
10. A third-party sale price could include additional elements of value in the form of a control premium for financial control or synergies.
11. Entire fairness cases involve the majority shareholder breaching his/her fiduciary duties often in a corporate action such as a squeeze-out merger, an action that was not fair to the minority shareholder.
12. Chapter 3 in Fishman, Pratt, and Morrison, *Standards of Value*, 102.
13. Huff v. Ckx, No. 6844-VCG, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013), *aff'd* Huff Fund Investment Partnership v. CKx, Inc., No. 348, 2014, 2015 WL 631586 (Del. Feb. 12, 2015).
14. Chapter 3 in Fishman, Pratt, and Morrison, *Standards of Value*, 123.
15. Ibid.
16. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).
17. Chapter 3 in Fishman, Pratt, and Morrison, *Standards of Value*, 139.
18. "FV Standard Provides 'Excessive Relief' When Oppressed S/h Wants to Sell," *Business Valuation Update* (June 2011).



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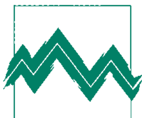

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Shareholder Oppression Claims in Texas: Current Developments, Considerations, and What Remains

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On June 24, 2014, in Ritchie v. Rupe, *the Texas Supreme Court changed the landscape of shareholder oppression claims in Texas, refusing to recognize a common-law cause of action for shareholder oppression and limiting relief to a receivership under the receivership statute. This discussion examines the history of shareholder oppression law in Texas, and this discussion considers the current state of the cause of action in light of this* Rupe *decision.*

Introduction

Until recently, shareholder oppression claims were increasingly common in the State of Texas. However, on June 24, 2014, in *Ritchie v. Rupe*, the Texas Supreme Court "declin[ed] to recognize or create a Texas common-law cause of action for 'minority oppression,'"[1] restricting the ability of noncontrolling shareholders to seek redress for oppressive acts, and providing a stricter definition of oppression than previously used by Texas courts.

This discussion examines the history of shareholder oppression law in Texas and considers the current state of this cause of action in light of the *Rupe* decision.

At its core, shareholder oppression involves a controlling shareholder acting as a "bully." The oppressor, or the controlling shareholder, is tantamount to the biggest kid on the playground with the nicest toys and is blessed with the power to make decisions for the entire playground (a controlling stake in the corporate entity) regardless of the interests or rights of the smaller kids. The smaller kids, or the oppressed noncontrolling shareholders, on the other hand, seem and feel powerless on the playground.

Noncontrolling shareholders have long searched for a solution to perceived abuses by the controlling shareholder. Shareholder oppression has evolved in fits and starts to provide this remedy.

The evolution of the shareholder oppression remedy has borrowed heavily over the years from related causes of action (e.g., fiduciary duty) and has been guided by ad hoc equitable remedies created by the courts. The increase in popularity of such claims mirrors shareholder remedies such as derivative suits designed to protect noncontrolling shareholders in publicly traded entities.

Prior to *Rupe*, several Texas courts of appeals have endorsed shareholder oppression and provided lengthy definitions of what constitutes such oppression, along with various forms of relief. Despite the *Rupe* decision, debate concerning the value of and necessity for shareholder oppression claims undoubtedly will continue in Texas and elsewhere.

There are certain noteworthy aspects of shareholder oppression law in Texas which should be taken into account. The first consideration is the background of oppression and its history. The second consideration in the area of shareholder oppression claims is choice of law.

Indeed, the determination of what body of law applies to a shareholder oppression claim is critical. Given the wildly differing definitions of oppression amongst the states, knowing what law to apply is

critical. The assumption that Texas law applies may not be warranted.

The differences between a shareholder oppression claim and a fiduciary duty claim should be studied prior to bringing suit, as similar facts characterizing the two claims may cause confusion. It is also important to note that in Texas, after the *Rupe* decision, there is no longer a recognized common-law cause of action for shareholder oppression. Accordingly, noncontrolling shareholders are limited to relief under the receivership statute and other common-law causes of action.

With a dynamic topic such as shareholder oppression, the unique facts of each case demand a thorough examination beyond that which is presented here. This is especially true with respect to closely held corporations where the personal dynamics of family and partnerships can result in more emotionally charged situations than typically accompany corporate governance disputes.

Choice of Law

Shareholder oppression law has evolved unevenly and sporadically across the country. Texas jurisprudence, for example, includes many oppression cases. The law in Delaware, on the other hand, is much more limited and much less explicit.

There are two theories on how to determine what law should apply to shareholder oppression cases. The first theory rests on the assumption that shareholder oppression is a tort and that, therefore, the "most significant relationship" test should apply. The second theory relies on an understanding of shareholder oppression as an outgrowth of corporate governance and applies the "internal affairs" doctrine.

The "Most Significant Relationship" Test

Some courts refer to shareholder oppression as a tort, suggesting at least possibly that choice of law for shareholder oppression should mirror choice of law for other torts.[2]

This is consistent with courts' understanding of shareholder oppression as "an expansive term that is used to cover a multitude of situations dealing with improper conduct . . . a narrow definition would be inappropriate."[3]

As a result, because oppression is a flexible remedy for conduct that, by definition, goes beyond any set standard for proper corporate conduct, it is a tort. Assuming oppression is a tort, the choice of law for shareholder oppression claims should arguably be governed by standard tort principles, and not the law that may govern the mechanics of corporate governance.

Texas courts apply the "most significant relationship" test to determine what law applies to the substantive portion of a tort dispute.[4]

Seven factors are considered:

1. The needs of the interstate and international systems
2. The relevant policies of the forum
3. The relevant policies of other interested states and the relative interests of those states in the determination of the particular issue
4. The protection of justified expectations
5. The basic policies underlying the particular field of law
6. Certainty, predictability, and uniformity of result
7. Ease in the determination and application of the law to be applied.[5]

In most shareholder oppression cases in Texas, this analysis suggests that Texas law (rather than the state of incorporation) applies. Under this framework, the choice of law analysis in shareholder oppression cases resembles the choice of law analysis in any negligence case.

The "Internal Affairs" Doctrine

The second way to determine choice of law evolves from the Texas "internal affairs" doctrine and rests on the assumption that shareholder oppression is an outgrowth of corporate governance and should be governed by the law of the state of incorporation.

In theory, because the mechanics of shareholder oppression rely on minority shareholders frozen out of the corporate decision-making process to their detriment—an inherently "internal" act—then it follows that the "internal affairs" doctrine ought to apply and dictate which state's law should apply.

Internal affairs are defined by statute as "(1) the rights, powers, and duties of its governing authority, governing persons, officers, owners, and members; and (2) matters relating to its membership or ownership interests."[6]

Under the statute, disputes regarding these issues are determined by the application of the state law of the state of incorporation.

Case law interpreting choice of law in shareholder oppression cases is scant, and the Texas courts have never directly addressed the issue. However, there are some parallels between oppression and a Fifth Circuit opinion applying the internal affairs doctrine.[7]

That case, *Sommers*, involved a claim for breach of fiduciary duty against the Employee Retirement Income Security Act of 1974 (ERISA) trustee.[8] *Sommers* was not an oppression case, but it did involve some "internal" corporate issues. The Fifth Circuit found that because the dispute centered on management of the entity, the Internal Affairs doctrine applied and dictated that the state of incorporation's law would apply.[9] Significantly, there was no allegation of oppression by one shareholder of another in *Sommers*.

At least one case, though not from Texas, has decided between the two tests. In *Conway*,[10] a New Jersey court expressly declined to apply the internal affairs doctrine to resolve a choice of law issue in a shareholder oppression suit, relying instead upon local state law by virtue of the "most significant relationship" test.

The New Jersey definition of shareholder oppression tracks closely to the one emerging in Texas. Accordingly, *Conway* may offer some guidance on how Texas courts may ultimately decide the issue.

The choice of law is an issue that should be addressed early in shareholder oppression cases. This is because different states have different laws concerning shareholder oppression.[11]

The Evolution of Common Law Oppression

Prior to discussing the Texas Supreme Court's ruling in *Rupe*, it is important to understand the evolution of shareholder oppression in Texas. Although much of the case law developed over the years is no longer controlling, it played a central part in influencing the Texas Supreme Court decision in refusing to recognize a common-law cause of action for shareholder oppression and limiting statutory relief.

Texas State Cases

Texas shareholder oppression law has developed sporadically. Prior to *Rupe*, the Texas Supreme Court last addressed oppression in *Patton*[12] in 1955. *Patton* provides a helpful lens through which to view courts' struggles to create appropriate remedies for abuse of the corporate entity by a controlling shareholder.

The facts of *Patton* mirror those of typical oppression cases. Patton owned Machinery Sales & Company as an unincorporated business to purchase and sell goods, wares, and merchandise.[13] In 1940, Patton assigned a 10 percent interest each to Nicholas and Parks, and three years later increased it to 20 percent each.[14]

In 1955, the business was incorporated.[15] Patton sought to revoke the assignment, but was met with contention and they settled all disputes.[16] Although the business had a "highly prosperous record" and a "high level of business," the books showed decreased earnings and no dividends were paid.[17]

Patton, as the founder of the business, president, and owner of a clear majority of the stock, controlled the board "for the malicious purpose of, and with the actual result of, preventing dividends and otherwise lowering the value (if meaning current sale value in the market place) of the stock of the respondents. . . ."[18]

The court considered the remedy of liquidation, but noted that liquidation should be the "extreme or ultimate remedy," as it usually will involve accentuation of the economic waste incident to many receiverships and forced sales.[19]

Rather, the court fashioned a new remedy, a mandatory injunction requiring the corporation and Patton, as the dominant officer and stockholder, to declare and pay at the earliest date a reasonable dividend of the stock of the corporation.[20]

The court considered this remedy "fair and even necessary, considering the malicious character of the misconduct" involved and the possibility of repetition.[21]

Therefore, although the court did not specifically recognize a cause of action for "shareholder oppression," it certainly considered oppressive facts and tailored a remedy to assist the noncontrolling shareholders. Though the word "oppression" does not appear in *Patton*, the case nevertheless lays the groundwork for ensuing cases, including *Rupe*.

Following *Patton*, the development of shareholder oppression idled for decades. The next substantive development in Texas shareholder oppression came with *Davis v. Sheerin* in 1988.[22]

Davis represented the first adoption of a "definition" for shareholder oppression by Texas courts—ultimately the same definition that faced review by the Texas Supreme Court in *Rupe*.

James Sheerin and William Davis incorporated a business in which Davis owned 55 percent and Sheerin owned 45 percent of stock.[23] Sheerin was not employed by the corporation, and five years later they formed a partnership to acquire real estate.[24]

Almost 30 years later in 1985, Sheerin brought suit against Davis based on oppressive conduct.[25] Sheerin alleged that he was denied access to the corporate books, unless he produced his stock certificate, but Davis claimed that Sheerin made a gift of his stock to him in the late 1960s.[26]

After a six-week jury trial, the trial court entered a favorable verdict for Sheerin.[27]

On appeal, the court of appeals clarified the definition of oppressive conduct, as the Texas Business Corporation Act did not—and does not—provide a definition.[28] The court noted that a court may "determine, according to the facts of the particular case, whether the acts complained of serve to frustrate the legitimate expectations of noncontrolling shareholders, or whether the acts are of such severity as to warrant the requested relief."[29]

Additionally, the court quoted language borrowed from other states that included "burdensome, harsh and wrongful conduct," as well as "a visible departure from the standards of fair dealing"[30] as the definition of oppression.

The court of appeals upheld the trial court's judgment of oppressive conduct and held that a "buy-out" was an appropriate remedy.[31] As more fully discussed below, the Texas Supreme Court in *Rupe* held that a buy-out remedy under the receivership statute is no longer available.[32]

Davis is significant both for the endorsement of a definition for shareholder oppression subsequently adopted by other courts and for enabling the "buy-out" remedy. *Patton* commanded a dividend, not a buy-out. Like *Patton*, however, *Davis* relies upon the equitable power of the court.

The amorphous category of acts that could constitute shareholder oppression took further shape in another Houston case, *Willis*. Relying upon the *Davis* definition of oppression, the court of appeals in *Willis* clarified that "routine" business behavior did not constitute oppression.[33]

Instead, the court ruled that something more than hiring and firing of employees who owned stock was necessary.

Willis involved the classic closely held corporation makeup of owner/employees. A group of people started the "Fill-Er-Up Club" by forming RMF & JB Corporation.[34] Bydalek ran the club and owned 49 percent of the stock.[35]

Relations between the parties soured, and Bydalek alleged that he was locked out rather than quitting or being fired.[36] Bydalek filed suit. After a favorable jury verdict, the trial court entered judgment on the shareholder oppression claim, and awarded damages equal to the value of Bydalek's stock, along with punitive damages.[37]

On appeal, however, the court of appeals disagreed that the jury verdict supported a finding of shareholder oppression.[38] The court noted that the "minority shareholder's reasonable expectations must be balanced against the corporation's need to exercise its business judgment and run its business efficiently."[39] The court considered whether the jury finding of a wrongful lock-out actually amounted to shareholder oppression rather than just a firing.

The court held that "Willis did not oppress minority shareholder Joseph Bydalek by firing him when (1) the jury found no wrong besides a lock-out, (2) the corporation and Willis, personally, always lost money, both before and after the lock-out, and (3) the Bydaleks were at-will employees."[40]

The court concluded that the firing alone was "simply not the sort of 'burdensome, harsh, or wrongful conduct' or 'visible departure from the standards of fair dealing' that may constitute shareholder oppression."[41]

The acknowledgement of the independent importance of "business judgment" in the context of oppression provided a potential limit to liability and an important delineation between oppression and simple business disagreements with a shareholder. Indeed, as discussed below, the Texas Supreme Court in *Rupe* held that "conduct is oppressive only if it is inconsistent with the honest exercise of business judgment."[42]

Oppression, under *Davis*, *Rupe*, and *Willis*, favors disputes that focus on the exercise of shareholder rights rather than disputes over the business itself. There is an important nexus between the two

that must be established to create an oppression claim.

Following *Willis*, another court of appeals opinion, this time from *Tyler*, clarified the scope of oppression yet again. This case affirmed that abuse of the corporate power for personal benefit may constitute oppression.[43]

G.E.M. Transportation was a trucking company. Griffith incorporated the company and transferred 25 percent of the corporation's stock to Redmon. Disputes arose between the parties and Griffith terminated Redmon's positions with the company. Redmon filed suit against G.E.M. and the Griffiths claiming, among other things, shareholder oppression.[44]

The trial court signed a final judgment ordering that the parties take nothing on their respective claims against one another.[45] The court of appeals considered whether Redmon presented sufficient summary judgment evidence to create a genuine issue of fact with regard to the shareholder oppression claim.[46]

> Evidence concerning the use of corporate funds to pay personal expenses combined with evidence that Jim Redmon was denied access to information concerning the financial condition of the corporation sufficiently creates a material fact issue concerning whether there was a lack of probity and fair dealing in the company's affairs to the prejudice of the Redmons or otherwise, a visible departure from the standards of fair dealing, and a violation of fair play on which minority shareholders like the Redmons were entitled to rely. We hold that the trial court incorrectly granted summary judgment on the Redmons claim for shareholder oppression.[47]

Redmon follows *Willis* in that it involved a dispute over management. The distinction, however, is that in *Redmon* the firing of a business associate and co-owner was coupled with evidence suggesting that the controlling shareholder had taken corporate funds to spend on personal expenses.

Texas Federal Cases

Federal courts in Texas have taken the lead from state appellate courts with respect to oppression claims. Although federal court decisions are scarcer, the facts and holdings have mirrored those in state cases.

One of the most frequently cited cases to address oppression in Texas federal courts is *Rosenbaum*.[48] This case involves a typical case of corporate misuse, complete with a bankruptcy. The Rosenbaums owned a company called Cornerstone to sell a goat de-wormer known as "Positive Pellets" to commercial distributors.[49] The Rosenbaums approached Gage to invest in Cornerstone.[50]

Rosenbaum informed Gage that Cornerstone would make a lot of money and that Gage could expect to be compensated through his interest as a majority shareholder; that they would be partners in profit.[51] Although these statements were false, Gage initially paid over $250,000 for 505,000 shares in Cornerstone.[52]

After lengthy dealings and further investments, the Rosenbaums filed for bankruptcy. Gage filed a lawsuit against the Rosenbaums and requested the bankruptcy court to liquidate his claims against the Rosenbaums for noncontrolling shareholder oppression and other claims.[53]

Gage sought to recover his principal payment to Cornerstone of $324,400 and to recover punitive damages.[54]

In considering Gage's claim for shareholder oppression, the court noted that there "is no set standard for determining whether shareholder oppression has occurred."[55]

The court took a more holistic view. "Rather, the Court must examine the facts as a whole and determine whether the corporation's conduct has deprived a minority shareholder of the shareholder's reasonable expectations as an equity holder of the corporation."[56]

This followed the "equitable" approach to shareholder oppression adopted by the Texas appellate courts. The court concluded that noncontrolling shareholder oppression had occurred, as the Rosenbaums acted in concert and dominated the control of Cornerstone.[57]

Specifically, their conduct was oppressive as they transferred all of Cornerstone's assets to themselves and defeated Gage's expectations, which were both reasonable under the circumstances and central to his decision to invest in Cornerstone.[58] Therefore, the court entered judgment for Gage.[59]

While *Rosenbaum* involves a more egregious set of facts than many cases, the bankruptcy court's reliance on Texas law provided a useful guideline for a federal court's interpretation of the law prior to *Rupe*.

In *Bulacher*,[60] an interesting case testing whether or not shareholder oppression was recognized or not in Texas through Federal 12(b)(6) practice, the Northern District of Texas analyzed the cause of action through the prism of an incipient shareholder oppression suit.

Bulacher was a former employee and current shareholder of Enowa, a software consulting services firm managed by defendants.[61] Bulacher owned 17 percent of outstanding stock and filed suit alleging shareholder oppression.[62]

Bulacher alleged that Enowa breached his employment contract by terminating him without 30 days' written notice and claimed that Enowa engaged in oppressive conduct by diluting and depriving him of the value of his interest in Enowa.[63]

The defendants filed a motion to dismiss, and the court denied the motion, holding that the facts alleged by Bulacher are sufficient to state a claim for shareholder oppression under Texas law.[64]

Relying on *Willis* and *Davis*, the court considered the two-part definition of shareholder oppression and noted that "Texas courts take a broad view of the application of oppressive conduct to a closely-held corporation such as Enowa."[65]

This expansive view of oppression relied directly on *Willis* and *Davis*, the two cases discussed *supra* which, prior to *Rupe*, constituted the most substantive discussions of oppression by Texas courts.

The common law history of shareholder oppression shows courts searching for solutions to abuse in the context of a closely held corporation, and resorting to their equitable power to create one. Accordingly, prior to *Rupe*, Texas courts cumulatively developed a coherent definition of shareholder oppression with important limitations where the dispute must affect the noncontrolling shareholder's rights and the corporation itself must become involved.

How Is This Not Breach of Fiduciary Duty?

Given their similar histories, a natural interplay has arisen between breach of fiduciary duty and shareholder oppression claims. The question becomes what, if anything, distinguishes the two—a point raised repeatedly by the petitioners in the *Ritchie v. Rupe* briefing in the Texas Supreme Court and by the court itself.

Indeed, the court in *Rupe* noted that "the kinds of actions that support a shareholder action for receivership under the 'oppressive' prong of the statute are the kinds of conduct that also may support other causes of action, such as breach-of-fiduciary-duties to the corporation."[66]

The similarity between breach of fiduciary duty and shareholder oppression is in the presumably "close" relationship between plaintiff and defendant. The difference arises in how a party exercises his or her authority to violate the "trust" that arises between the two as a result of that relationship.

In the case of breach of fiduciary duty, the "breach" manifests itself through the offending party first being in a fiduciary relationship, including a broad range of behaviors from taking money from a trust account to drafting a document that is lopsided in favor of the fiduciary. In the case of shareholder oppression, the distinction is mechanical.

The controlling shareholder takes advantage of his superior position to use the corporation to his own benefit, to the injury of the noncontrolling shareholders. The noncontrolling shareholder, due to the makeup of the closely held corporation, does not have the necessary leverage to resist the controlling shareholder.

This fact victimizes the noncontrolling shareholder less in his relationship to the controlling shareholder than in his relationship to the corporation—undermining the expectations which led him to invest in the venture or to hold stock in the venture to begin with.

The relationship aspect of a shareholder oppression claim is geared less towards the controlling shareholder than towards the noncontrolling shareholder's frustrated relationship with the corporation—a frustration caused by the controlling shareholder's use of the corporate procedure. Where the "majority will" of controlling shareholder is not in the best interest of the corporation but in the best interest of the controlling shareholder, courts see oppression.[67]

Ritchie v. Rupe

On June 24, 2014, the Texas Supreme Court, in *Ritchie v. Rupe*, drastically changed the landscape of shareholder oppression claims in Texas. The court refused to recognize a common-law cause of action for shareholder oppression, limiting relief to a receivership under the receivership statute. The court also held that the receivership cannot be appointed unless the trial court determines lesser remedies would not be adequate.

The court also adopted more arduous standards for "oppressive" conduct other than the "fair dealing" and "reasonable expectations" tests previously used in Texas and discussed above.

Oppression, under the receivership statute, can now only occur if a corporation's controlling shareholders, directors, or officers "abuse their authority over the corporation with the intent to harm the interests of one or more of the shareholders, in a manner that does not comport with the honest

exercise of their business judgment, and by doing so create a serious harm to the corporation."[68]

Background

Rupe involved claims for shareholder oppression filed by a minority shareholder of the Rupe Investment Corporation (RIC), a closely held corporation. The trial court determined that plaintiff and minority shareholder, Ann Caldwell Rupe, had been subjected to shareholder oppression by RIC and some of its shareholders.[69]

RIC and other shareholders refused to meet with prospective purchasers of the stock and refused to allow any RIC management personnel to meet with prospective purchasers.[70]

Among other issues on appeal, the Dallas Court of Appeals considered whether the majority shareholders' conduct was oppressive and defined oppression as follows:

> Texas courts have generally recognized two non-exclusive definitions for shareholder oppression: 1. majority shareholders' conduct that substantially defeats the minority's expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority shareholder's decision to join the venture; or 2. burdensome, harsh, or wrongful conduct; a lack of probity and fair dealing in the company's affairs to the prejudice of some members; or a visible departure from the standards of fair dealing and a violation of fair play on which each shareholder is entitled to rely.[71]

In considering what constitutes reasonable expectations, the court of appeals distinguished between specific and general reasonable expectations.[72]

Specific reasonable expectations are those specifically agreed to or expected as part of the transactions that develop over time, while general expectations are those that arise from the status of being a shareholder.[73]

The burdensome or oppressive definition "will often overlap the reasonable expectations definition because the standards of fair dealing on which all shareholders are entitled to rely will often include conduct necessary to meet the reasonable expectations of shareholders."[74]

The court of appeals ultimately held that the majority shareholders' conduct was oppressive in "refusing to meet or allow any officer or director of RIC to meet with prospective purchasers of the Stock because that conduct in this case substantially defeated Ann's general reasonable expectation of marketing the Stock."[75]

As a noncontrolling shareholder in a closely held corporation, the court held that Rupe had a general reasonable expectation that she could market the stock to third parties at whatever price the market would bear.[76]

The court of appeals also held that a "buy-out" remedy was available to Rupe whereby one remedy for the majority's oppression was a purchase by the majority of her stock at fair market value.[77]

Further, the court of appeals noted that "it is also reasonable to expect that the corporation and its management (as part of the standards of fair dealing on which all shareholders are entitled to rely) will consent to a shareholder's reasonable requests for cooperation with respect to her efforts to sell the stock."[78]

No Texas Common Law Cause of Action for Shareholder Oppression

The Texas Supreme Court reversed and remanded the case, holding that a common-law action for shareholder oppression is undesirable because it would require the adoption of a meaning of oppressive conduct that is different from the definition in the statutory receivership cause of action, as it "would merely duplicate the statutory cause of action while permitting remedies that the Legislature has chosen not to permit."[79]

Further, the "most developed common-law standards for 'oppression'—the 'reasonable expectations' and 'fair dealings' tests—have been heavily criticized for their lack of clarity and predictably."[80]

Additionally, the court noted that creating a common law cause of action is similar to "imposing on directors and officers a fiduciary duty to individual shareholders" and it would "permit courts to interfere with the freely negotiated terms of a private contract, or to insert into such a contract rights or obligations that the parties could have bargained for but did not."[81]

Defining Oppression in Texas

Rupe relied on the receivership statute as "authority for the trial court's judgment ordering RIC to buy out her shares."[82] The court, therefore, examined the receivership statute to determine the meaning of "oppressive."[83]

Texas does not have an "oppression" statute. The receivership statute, "former article 7.05 of the Texas Business Corporations Act, and its successor, section 11.404 of the Texas Business Organizations

Code, authorize Texas courts to appoint a receiver to rehabilitate a domestic corporation under certain circumstances."[84]

The statute states that a receivership may be declared when "the actions of the governing persons of the entity are illegal, ***oppressive***, or fraudulent."[85] Prior to *Rupe*, this statute was often relied upon by parties resisting a common-law shareholder oppression claim because the remedy was presumed superior to some of the previously available common-law remedies for shareholder oppression, particularly the "buy-out" remedy.[86]

Indeed, the petitioners in *Rupe* argued that the existence of this statute makes shareholder oppression unnecessary if not dangerous.[87]

In its decision, the Texas Supreme Court acknowledged "that the Legislature has never defined the term 'oppressive' in the Business Corporations Act or the Business Organizations Code."[88] It held that oppressive conduct had to "create exigent circumstances for the corporation."[89]

Indeed, the court noted that other scenarios where an appointment of a receiver was necessary involved situations that "pose[d] a serious threat to the well-being of the corporation."[90]

Further, oppressive conduct could not be conduct that was good for the corporation, even if bad for an individual shareholder.[91] The court held that "because a director is duty-bound to exercise business judgment for the sole benefit of the corporation, and not for the benefit of individual shareholders, [it could not] construe the term 'oppressive' in a manner that ignores that duty."[92]

Accordingly, conduct is oppressive only if it is "inconsistent with the honest exercise of business judgment and discretion by the board of directors."[93]

The court identified at least three characteristics of "actions" that the statute refers to as "oppressive":

1. The actions justify the harsh, temporary remedy of a rehabilitative receivership

2. The actions are severe and create exigent circumstances

3. The actions are inconsistent with the directors' duty to exercise their honest business judgment for the benefit of the corporation[94]

The court also provided a fourth characteristic that "the actions involve an unjust exercise or abuse of power that harms the rights or interests of persons subject to the actor's authority and disserves the purpose for which the power is authorized.[95]

The court noted that "[a]ctions that uniformly affect all shareholders typically will not satisfy this aspect of the term's meaning because, collectively, the shareholders of a business are not at the mercy of the business's directors."[96]

". . . conduct is oppressive only if it is 'inconsistent with the honest exercise of business judgment and discretion by the board of directors.'"

The court held that neither of the two tests previously used (the reasonable expectations and fair dealings tests) were appropriate because, in light of the above-mentioned characteristics, neither would be rigorous enough.[97]

The court held that the conduct was not oppressive because "the evidence does not support a finding that they abused their authority with the intent to harm Rupe's interests in RIC, or that their decision created a serious risk of harm to RIC."[98]

The conduct made it difficult for Rupe to sell her shares, but "[s]hareholders of closely held corporations may address and resolve such difficulties by entering into shareholder agreements."[99]

Remedies

Prior to *Rupe*, the equitable origins of shareholder oppression resulted in a broad but uncertain spectrum of potential remedies. From *Patton's* reliance upon a forced dividend, to the *Davis* endorsement of a so-called "buy-back," remedies for shareholder oppression were not clearly defined. These remedies compared favorably to the receivership statute, which places the minority shareholder's fate in the hands of a third party and may ultimately provide less value.

With the court's ruling in *Rupe*, shareholder oppression actions are now limited to the receivership statute and other common-law causes of action available to minority shareholders.

Receivership Statute

The limits of the receivership statute make it an attractive fire wall for defendants in shareholder oppression cases who seek to limit both the remedies available to plaintiffs and heighten the standard for liability.

The court in *Rupe* held that the lower court erred in ordering a buy-out of Rupe's shares because the provision relied upon in the receivership statute states, "[a] court may appoint a receiver under

“The Texas Supreme Court holding . . . eliminates the common-law cause of action for shareholder oppression, while endorsing other remaining common-law and statutory causes of action for minority shareholders.”

Subsection (a) only if . . . the court determines that all other available legal and equitable remedies . . . are inadequate.”[100] The lower court, therefore, had to consider lesser remedies first before ordering the buy-out.[101]

Going forward, trial courts will have to consider other forms of relief that provide lesser remedies. If lesser remedies are available, the trial court cannot appoint a receiver.[102]

Other Remedies

The Texas Supreme Court noted that it was not limiting remedies available under common law or statutes. Indeed, the court noted that “shareholders may also prevent and resolve common disputes by entering into a shareholders’ agreement to govern their respective rights and obligations.”[103]

It stated that “the Legislature has granted corporate founders and owners broad freedom to dictate for themselves the rights, duties, and procedures that govern their relationship with each other and with the corporation.”[104]

Further, the court noted the various common-law causes of action that still exist to protect noncontrolling shareholders such as actions for “(1) an accounting , (2) breach of fiduciary duty, (3) breach of contract, (4) fraud and constructive fraud, (5) conversion, (6) fraudulent transfer, (7) conspiracy, (8) unjust enrichment, and (9) quantum meruit.”[105]

Indeed, the court remanded the case to the court of appeals so that it could resolve any of the challenges to the breach of fiduciary duty claim alleged by Rupe.[106]

Conclusion

Shareholder oppression has certainly evolved in Texas, becoming increasingly popular in recent years. However, the Texas Supreme Court decision in *Rupe* sets forth limitations that will undoubtedly alter shareholder oppression claims for years to come.

Breach of fiduciary duty suits differ in their scope and their facts, while statutory shareholder oppression remains relatively underdeveloped and comparatively less friendly from the standpoint of remedies, especially given the holding in *Rupe*. In addition, the uncertain choice of law analysis for oppression creates numerous potential pitfalls for the unwary practitioner.

Choice of law, for example, creates issues that should have an impact on many corporate transactions, especially when choosing the state of incorporation due to the internal affairs doctrine.

The Texas Supreme Court holding in *Rupe* eliminates the common-law cause of action for shareholder oppression, while endorsing other remaining common-law and statutory causes of action for minority shareholders. A claim for shareholder oppression is now limited to Texas Business Organizations Code Section 11.404 and the only remedy available under it is a rehabilitative receivership.

In fact, on June 27, 2014, in *Cardiac Perfusion Services, Inc. v. Hughes*, the Texas Supreme Court, citing *Rupe*, reversed the lower court’s decision, which ordered a buy-out of shares for shareholder oppression.[107]

The court in *Rupe* also adopted more arduous standards for “oppressive” conduct under the receivership statute other than the “fair dealing” and “reasonable expectations” tests previously used in Texas.

Oppression now occurs only if a corporation’s controlling shareholders, directors, or officers “abuse their authority over the corporation with the intent to harm the interests of one or more of the shareholders, in a manner that does not comport with the honest exercise of their business judgment, and by doing so create a serious risk of harm to the corporation.”[108]

Even without a common-law cause of action for shareholder oppression and a more limited receivership statute, noncontrolling shareholders still have various other avenues to recovery if they have been wronged. Not only can they still use the receivership statute, but noncontrolling shareholders can also use existing causes of action under Texas law to address misconduct, including claims for breach of fiduciary duty.

Moreover, as the court in *Rupe* noted, noncontrolling shareholders can protect themselves at the onset “by entering into shareholder agreements that contain buy-sell, first refusal, or redemption provisions that reflect their mutual expectations of agreements.”[109]

Notes:

1. Ritchie v. Rupe, 443 S.W.3d 856, 860 (Tex. 2014), *reh’g denied* (Oct. 24, 2014).
2. See Cotten v. Weatherford Bancshares Inc., 187 S.W.3d 687, 702 (Tex. App.—Ft. Worth 2006, *pet. denied*) (considering oppression as a potential “underlying tort” to civil conspiracy); Willis

v. Donnelly, 118 S.W.3d 10, 30-31 (Tex. App.—Houston [14th Dist.] 2003), *aff'd in part and rev'd in part on other grounds*, 199 S.W.3d 262 (Tex. 2006) (determining that the breach of fiduciary duty elements of an oppression claim "sound in tort").

3. Davis v. Sheerin, 754 S.W.2d 375, 381 (Tex. App.—Houston [1st Dist.] 1988, *writ denied*).
4. Hughes Wood Prods. Inc. v. Wagner, 18 S.W.3d 202, 205 (Tex. 2000); Torrington Co. v. Stutzman, 46 S.W.3d 829, 847-50 (Tex. 2000); Gutierrez v. Collins, 583 S.W.2d 312, 318 (Tex. 1979).
5. Wagner, 18 S.W.3d at 205; Torrington Co., 46 S.W.3d at 847-50.
6. Tex. Bus. Org. Code § 1.105 (Vernon 2012).
7. Sommers Drug Stores Co. Emp. Profit Sharing Trust v. Corrigan, 883 F.2d 345 (5th Cir. 1989).
8. *Id.* at 348.
9. *Id.*
10. Conway v. DialAmerica Marketing, Inc., No. BER-C-116-08 (N.J. Super. Ct. Ch. Div. Sept. 30, 2008).
11. Delaware, for instance, has only one case on record which has squarely addressed oppression, Litle v. Waters, No. 12155, 1992 WL 25758 (Del. Ch. 1992). Further, Delaware courts have shied away from recognizing a common law tort of oppression, Nixon v. Blackwell, 626 A.2d 1366 (Del. 1993).
12. Patton v. Nicholas, 279 S.W.2d 848 (Tex. 1955).
13. Patton, 279 S.W.2d at 849.
14. *Id.*
15. *Id.*
16. *Id.* at 850.
17. *Id.* at 851.
18. *Id.* at 852.
19. *Id.* at 856-57.
20. *Id.* at 857.
21. *Id.* at 858.
22. Davis v. Sheerin, 754 S.W.2d 375 (Tex. App.—Houston [1st Dist.] 1988, *writ denied*).
23. Davis, 754 S.W.2d at 377.
24. *Id.*
25. *Id.*
26. *Id.*
27. *Id.* at 378.
28. *Id.* at 381.
29. *Id.* (citations omitted).
30. *Id.* at 382 (citations omitted).
31. *Id.* at 383.
32. Ritchie v. Rupe, 443 S.W.3d 856 (Tex. 2014), *reh'g denied* (Oct. 24, 2014).
33. Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, *pet. denied*).
34. Willis, 997 S.W.2d at 799.
35. *Id.* at 800.
36. *Id.*
37. *Id.* at 800—01.
38. *Id.* at 801.
39. *Id.* (citation omitted).
40. *Id.* at 802.
41. *Id.* at 802—03.
42. Ritchie v. Rupe, 443 S.W.3d 856, 869 (Tex. 2014), *reh'g denied* (Oct. 24, 2014) (internal citations omitted).
43. Redmon v. Griffith, 202 S.W.3d 225 (Tex. App.—Tyler 2006, *pet. denied*).
44. Redmon, 202 S.W.3d at 231.
45. *Id.*
46. *Id.*
47. *Id.* at 236.
48. In re Rosenbaum, No. 08-43029, 2010 WL 1856344 (Bankr. E.D. Tex. 2010).
49. Rosenbaum, 2010 WL 1856344, at *1.
50. *Id.* at 2.
51. *Id.*
52. *Id.* at 3.
53. *Id.* at 6.
54. *Id.*
55. *Id.* at 7 (citations omitted).
56. *Id.* (citations omitted).
57. *Id.*
58. *Id.*
59. *Id.* at 13.
60. Bulacher v. Enowa, L.L.C., No. 3:10-CV-156-M, 2010 WL 1135958 (N.D. Tex. March 23, 2010).
61. Bulacher, 2010 WL 1135958, at *1.
62. *Id.*
63. *Id.*
64. *Id.* at *2.
65. *Id.* (citations omitted).
66. Ritchie v. Rupe, 443 S.W.3d 856, 873 (Tex. 2014), *reh'g denied* (Oct. 24, 2014).
67. Rupe, 339 S.W.3d at 289 (citing Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, *pet. denied*); Redmon v. Griffith, 202 S.W.3d 225, 234 (Tex. App.—Tyler 2006, *pet. denied*); Pinnacle Data Servs., Inc. v. Gillen, 104 S.W.3d 188, 196 (Tex. App.—Texarkana 2003, no pet.); In re Rosenbaum, No. 08-43029, 2010 WL 1856344 at *7 (Bankr. E.D. Tex. May 7, 2010) (finding oppression as a result of misrepresentation and self-dealing, noting the defendants' "purposeful actions to dilute the value of [plaintiff's] investment while employing the business and its assets solely for their own benefit"); Davis v. Sheerin, 754 S.W.2d 375, 377-78, 382 (Tex. App.—Houston [1st Dist.] 1988, *writ denied*) (finding oppression in a case in which the

majority shareholders conspired to deprive the plaintiffs of their stock interest in the company by causing distributions to flow to themselves rather than the plaintiffs, while using corporate assets to pay their legal fees. The court found this plan and these actions were clearly oppressive because they not only substantially defeated the plaintiffs' reasonable expectations about stock ownership, but "would totally extinguish such expectations.").

68. Ritchie v. Rupe, 443 S.W.3d 856, 871 (Tex. 2014), *reh'g denied* (Oct. 24, 2014).
69. Rupe, 339 S.W.3d at 289.
70. *Id.* at 281.
71. Rupe, 339 S.W.3d at 289 (citing Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, *pet. denied*); Redmon v. Griffith, 202 S.W.3d 225, 234 (Tex. App.—Tyler 2006, *pet. denied*); Pinnacle Data Servs., Inc. v. Gillen, 104 S.W.3d 188, 196 (Tex. App.—Texarkana 2003, *no pet.*). This definition mirrors the one that slowly emerged in Texas law following the decision in Davis v. Sheerin, 754 S.W.2d 375 (Tex. App.—Houston [1st Dist.] 1988, *writ denied*), discussed infra.
72. Rupe, 339 S.W.3d at 290.
73. *Id.* at 291.
74. *Id.* at 294.
75. *Id.* at 296.
76. *Id.* at 294.
77. *Id.* at 302 (remanding to decide how to quantify "fair value").
78. *Id.* Prior to the Texas Supreme Court decision, Rupe was already relied upon by other Texas appellate courts analyzing oppression, most significantly and recently by Feldman and Konkel. In Feldman, a group of Houston urologists formed a Professional Association, Limited Partnership, and an LLC. Feldman, 2012 WL 1449726, at *1. When one of the urologists, Bernard Feldman, decided to wind down his practice and retire, he alleged that the other doctors began to freeze him out and defeat his legitimate and reasonable expectations for investing in the entities. *Id.* at *1-2. He filed suit claiming oppressive conduct, and the trial court granted summary judgment in favor of the defendants. *Id.* at *2. Noting that Texas recognizes a cause of action for shareholder oppression, the Houston Court of Appeals considered the summary judgment evidence and held that the defendants failed to meet their burden to establish, as a matter of law, "that their conduct did not fall within either definition of shareholder oppression…." *Id.* at *5. Feldman relied heavily upon Rupe in reaching its conclusions. Likewise, in Konkel, the Houston Court of Appeals held that the "acts found by the jury to have occurred in this case substantially defeated Konkel's general reasonable expectations as a [minority] shareholder." Konkel, 404 S.W.3d at 33. In reaching its decision, the Court quoted both definitions of oppression, focusing on Rupe's "reasonable expectations" *Id.*
79. Ritchie v. Rupe, 443 S.W.3d 856, 889 (Tex. 2014), *reh'g denied* (Oct. 24, 2014)
80. *Id.* at 890.
81. *Id.*
82. *Id.* at 863.
83. *Id.* Id.
84. Ritchie v. Rupe, 443 S.W.3d 856, 863 (Tex. 2014), *reh'g denied* (Oct. 24, 2014); TEX. BUS. ORGS. CODE § 11.404.
85. TEX. BUS. ORGS. CODE § 11.404(a)(1)(C) (emphasis added).
86. Ritchie v. Rupe, 339 S.W.3d at 289.
87. Petitioner's Brief on the Merits at *25, Ritchie v. Rupe (No. 11-0447) (filed June 13, 2012).
88. Ritchie v. Rupe, 443 S.W.3d 856, 866 (Tex. 2014), *reh'g denied* (Oct. 24, 2014).
89. *Id.* at 867.
90. *Id.* at 868.
91. *Id.* at 884.
92. *Id.* at 868.
93. *Id.* at 869.
94. Ritchie v. Rupe, 443 S.W.3d 856, 870 (Tex. 2014), *reh'g denied* (Oct. 24, 2014).
95. *Id.*
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98. *Id.* at 871.
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100. Ritchie v. Rupe, 443 S.W.3d 856, 898 (Tex. 2014), *reh'g denied* (Oct. 24, 2014).
101. *Id.*
102. *Id.* at 875.
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106. Ritchie v. Rupe, 443 S.W.3d 856, 882 (Tex. 2014), *reh'g denied* (Oct. 24, 2014).
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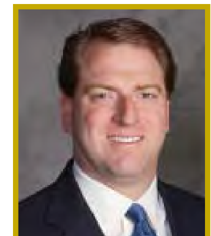

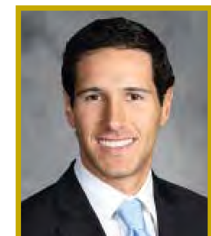

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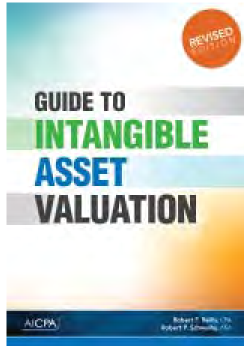

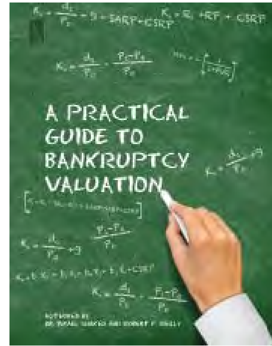

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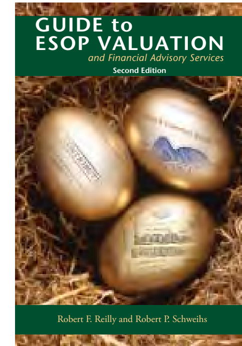

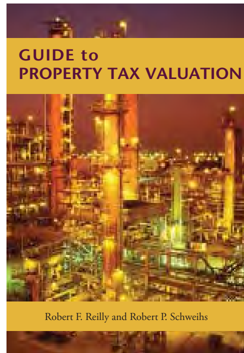

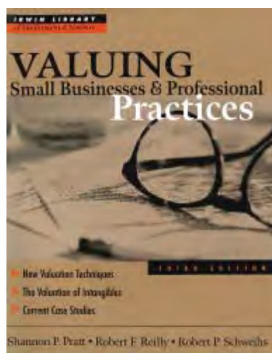

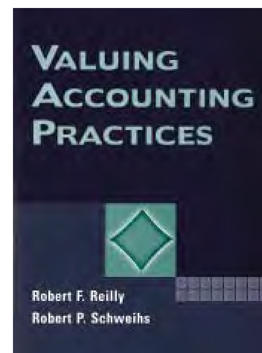

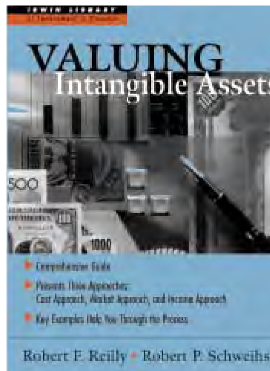

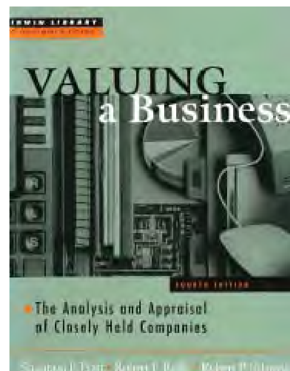

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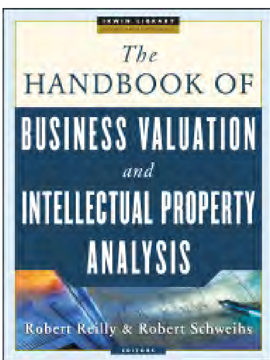

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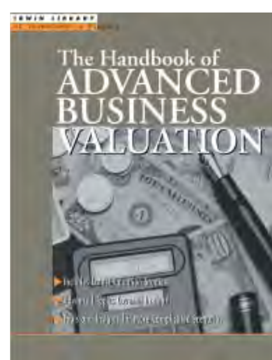

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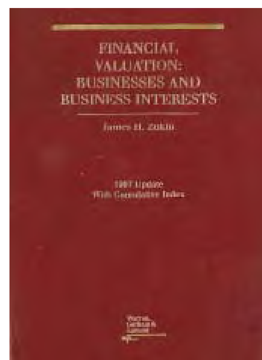

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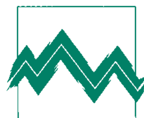

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Fair Value of Banks and Depository Institutions in Dissenting Shareholder Appraisal Actions—Understanding and Addressing Their Unique Operational Traits and Delaware Court Guidance

Justin M. Nielsen and Stephen P. Halligan

A bank or depository institution may be the subject of a dissenting shareholder appraisal rights action or a shareholder oppression action, similar to any other corporation. In estimating the fair value of the bank or other depository institution, the valuation analyst should consider the unique characteristics associated with these types of entities. There are special considerations related to (1) segregating operating and financing activities and (2) estimating the effects of the regulatory environment on the subject industry. These special considerations require the valuation analyst to understand the valuation impact of these and other characteristics that are important to the bank and depository institution industry. This discussion addresses shareholder appraisal rights actions and provides insight into the special considerations appropriate to estimate the fair value of a bank or other depository institution.

Introduction

By definition, a dissenting shareholder appraisal rights action ("appraisal action") is a statutory remedy that is available in certain states to noncontrolling corporate stockholders who object to certain actions taken by the corporation, such as mergers.

The appraisal action provides an option to the dissenting shareholders that would require the corporation to repurchase the shareholders' stock at a price equivalent to the corporation's value immediately prior to the corporate action.

Generally in an appraisal action, the standard of value is fair value. For these purposes, fair value is typically defined as the pro rata business enterprise value that is not discounted either for lack of marketability or for lack of control. In addition, fair value takes into account all relevant factors known or ascertainable as of the valuation date, excluding any synergistic value.

A bank or depository institution can be the subject of a dissenting shareholder appraisal rights action, similar to other corporations. However, the estimation of the fair value of a bank or depository institution includes many subtle, and not so subtle, differences as compared to estimating the fair value of corporations operating in other industries.

Generally, the unique complexities of valuing a bank or depository institution originate from two distinct operating characteristics. These two

characteristics suggest that the valuation analyst understand and diligently apply appropriate valuation procedures in estimating the fair value of a bank or depository institution within an appraisal action.

The Delaware Court of Chancery (the "Court"), which decides matters concerning shareholder equity claims in Delaware, is generally viewed as an important forum for ruling on dispute litigation involving matters related to shareholder dissent (including bank and depository institution appraisal actions).

With its significant influence on valuation-related matters, attorneys and valuation analysts alike frequently look to the Court for guidance regarding the appropriate methodology to value business interests for purposes of appraisal actions.

The goals of this discussion are as follows:

1. To introduce appraisal actions and the Court's preference for the discounted cash flow (DCF) valuation method
2. To describe some of the unique characteristics associated with estimating the fair value of a bank or depository institution within a shareholder appraisal action
3. To explain the importance of the subject company industry (i.e., the bank or depository institution industry) when applying the DCF valuation method within a shareholder appraisal action

Shareholder Appraisal Actions

As a large number of business entities within the Unites States are organized in the State of Delaware, the Court has become an influential voice in providing guidance related to appraisal action business valuation issues.

There are several categories of shareholder disputes. Common types of shareholder disputes include the following:

1. Dissenting shareholder appraisal rights (i.e., appraisal actions)
2. Shareholder oppression claims
3. Noncontrolling shareholder "freeze-out" actions
4. Breach of noncompete agreements
5. Purchase/sale agreement disputes
6. Shareholder derivative actions

In a shareholder appraisal action, a noncontrolling shareholder has the right to object or dissent to certain extraordinary actions taken by the corporation, such as a merger. The "appraisal remedy" requires the corporation to repurchase the shareholder's stock at a price equivalent to the corporation's value immediately prior to the corporate action.

This discussion focuses on calculating an opinion of value (i.e., fair value) of a bank or depository institution when applying the income approach, and, specifically, the DCF method within an appraisal action.

The DCF Method

Within the income approach, there are a number of generally accepted valuation methods. Each of these generally accepted valuation methods is fundamentally based on the premise that the value of an investment is a function of the economic income that will be generated by that investment over its expected economic life.

There are a number of income approach valuation methods that can be used to estimate value under this premise, most of which are based on:

1. the estimation of an investment's future economic earnings stream and
2. the application of an appropriate risk-adjusted, present value discount/direct capitalization rate.

The DCF method is a generally accepted method that may be used to value companies on a going-concern basis. The DCF method has appeal because it incorporates the trade-off between risk and expected return, one component to the investment decision and value calculation process.

The DCF method provides an indication of value by (1) estimating the future economic earnings of a business and (2) estimating an appropriate risk-adjusted required rate of return used to discount the estimated future economic earnings back to present value.

There are many factors a valuation analyst may consider in developing the discount rate that reflects the related risk associated with the future company economic earnings (i.e., procedure two in the DCF method). This discussion focuses on the development and application of the projected future economic earnings used in the DCF method (i.e., procedure one in the DCF method).

In defining the estimated future economic earnings of a business, there are a number of common measurements, such as the following:

1. Dividends or partnership distributions

2. Net cash flow to equity or net cash flow to invested capital (i.e., the total market value of company debt and equity)
3. Various accounting measures of income such as net income, net operating income, and several others

The valuation analyst's responsibility is to align the appropriate earnings measure to the subject of the valuation. Generally, if the valuation subject is the value of equity, then the appropriate earnings measure is "cash flow to equity." Similarly, if the valuation subject is the business enterprise, then the appropriate earnings measure is "cash flow to the firm" or "cash flow to invested capital."

Once the valuation analyst determines the appropriate measure of economic earnings to apply in the DCF method, the next procedure is to estimate the estimated earnings over a defined future time period.

One Court-preferred method for estimating the future economic earnings of a business is to obtain from company management financial projections of the company's profitability generated during the normal course of operations and used for general management planning purposes.

Appraisal Actions—the Court and the DCF Method

Prior to 1982, the "Delaware block" was often used by the Court as the preferred method to valuation in an appraisal hearing. The Delaware block method entailed assigning specific weights to certain elements of value, such as total assets, current market price, and company earnings.

The Court ultimately opined that the Delaware block method was archaic and that it excluded other generally accepted valuation approaches and methods that were being used by the financial community and the courts.

In critiquing the Delaware block method, the Court opined in *Weinberger v. UOP, Inc., et al.*:

> Accordingly, the standard "Delaware Block" or weighted average method of valuation . . . employed in appraisal and other stock valuation cases, shall no longer exclusively control such proceedings. We believe that a more liberal approach must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible. . . ."[1]

As further documented in various judicial opinions, the Court has demonstrated that one appropriate method in valuing a dissenting shareholder's stock may be the DCF method. As opined in *Crescent/Mach I P'ship, L.P. v. Turner* and *Cede & Co. v. JRC Acquisition Corp.*, respectively:

> [T]he Court tends to favor the discounted cash flow method ("DCF"). As a practical matter, appraisal cases frequently center around the credibility and weight to be accorded the various projections for the DCF analysis.[2]

> In recent years, the DCF valuation methodology has featured prominently in this court because it "is the approach that merits the greatest confidence" within the financial community.[3]

The Court has addressed some preference for the DCF method in bank and depository institution appraisal actions as well. As opined in *Union Illinois v. Union Financial Group*:

> Under Delaware law, it would be appropriate for me to give heavy weight to the value of UFG [Union Financial Group, Ltd.] as implied by a DCF analysis. For example, I could use the generous assumptions I used to test the Merger Price and award the O'Briens $5.44 per share. Or, I could give that value equal weight to the Merger Price.[4]

It should be noted, however, that according to valuation professional standards, the valuation analyst should consider all available valuation approaches and methods when estimating the value of a dissenting shareholder's stock. Of course, the objective of using more than one valuation approach is to develop mutually supporting evidence as to the conclusion of value.

Nevertheless, while the valuation analyst should consider all available valuation approaches and methods, the DCF method is generally viewed by the Court as an appropriate method in valuing a dissenting shareholder's stock, including a bank or depository institution dissenting shareholder's stock, assuming the company can reasonably project performance beyond the next fiscal year.

The following section addresses some of the issues that the valuation analyst should consider in estimating the fair value of a bank or depository institution within a shareholder appraisal action context.

Estimating the Fair Value of a Bank or Depository Institution in an Appraisal Action—the DCF Method

While all industries possess differing operational characteristics and value-driver nuances, the financial services industry, and specifically the bank and depository institution industry, has distinct operating characteristics the valuation analyst should consider when estimating fair value within an appraisal action.

Generally acting as intermediaries between those who save money and those who borrow money, the principal activities for banks and depository institutions include the collection of deposits and the subsequent disbursement of loans.

Banks typically generate more than half of their annual revenue through the "earned spread," which is more commonly identified as net interest income. The earned spread is the difference between (1) the interest rate the bank or depository institution can charge on loans made and (2) the interest rate the bank or depository institution can pay on the customer deposits.

Interest income is classified as an operating activity for banks and depository institutions, rather than a nonoperating source of revenue. This accounting treatment is different when compared to other industries.

Additionally, banks or depository institutions use what may be viewed as debt (i.e., customer deposits) as a funding source to facilitate their day-to-day operations, which obligates them to categorize interest expense as an operating expense rather than a nonoperating expense.

Other products and services offered by banks and depository institutions can vary widely as a result of each corporation's established core competency. As a result of the Gramm-Leach-Bliley Financial Services Modernization Act of 1999, these products and services have expanded into related financial fields such as the following:

1. Investment management
2. Mutual funds
3. Insurance
4. Municipal finance
5. Corporate investment banking

As such, the nature of these additional services provided by banks and depository institutions warrants a high level of industry regulation. And industry oversight has only increased with the advent of new regulations (e.g., the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010).

These regulations include increasingly strict enforcement and disclosure requirements, as well as detailed accounting rules that do not typically apply to other industries.

Therefore, the aforementioned characteristics (i.e., atypical operating accounting methods and rules and stringent financial regulations) create certain methodological challenges when applying the DCF model to estimate the fair value of a bank or depository institution.

Two fundamental operating characteristics associated with the bank and depository institution industry are addressed below:

1. The issue of separating operating and financing expenses and their respective implications on (a) measuring cash flow and (b) defining what constitutes debt and the cost of debt
2. The effects of the regulatory environment/subject company industry on (a) assessing the reasonableness of bank and depository institution management-prepared projections and (b) estimating the appropriate long-term growth rate used in the terminal value (TV) calculation (if applicable)

Cash Flow to Equity Models in Bank and Depository Institution Valuations

As presented above, the DCF model provides an indication of value by discounting an estimated measure of future economic earnings at an appropriate risk-adjusted rate of return. Generally, cash flow to the firm (CFF) and cash flow to equity (CFE)

are two common earnings measurements used in the DCF model.

The DCF model variation using CFF—the cash flow available to all the firm's suppliers of capital, after operating expenses (including taxes) and expenditures needed to sustain the firm's productive capacity are met—attempts to value firms by discounting expected cash flow prior to debt payments at the company's weighted average cost of capital (WACC).

As presented in the formula below, the general formula for CFF begins with net income and is adjusted to arrive at the cash flow available to all the firm's suppliers of capital (i.e., common and preferred stockholders and bondholders):

  Net income
+ Noncash charges
+ Interest expense * (1 – tax rate)
– Investments in fixed capital
– Investments in working capital
= Cash flow to the firm

Noncash charges and after-tax interest expense are added back to net income, while adjustments are made to subtract investments in fixed capital (i.e., capital expenditures) and investments in working capital from net income. Interest expense, which was subtracted from pretax income to obtain net income, is a cash flow available to one of the firm's capital providers (i.e., debt holders), and is, therefore, added back in the CFF calculation.

However, determining which interest expense to add back to net income can pose a significant issue in estimating the fair value of a bank or depository institution, as the valuation analyst would need to separate operating interest expense from financing interest expense—an area where there is no clearly defined line between the two.

Furthermore, debt balances and debt payments for banks and depository institutions are not easily defined. For example, banks and depository institutions receive deposits from customers and pay interest on a portion of these accounts, yet this action is not classified as an actual "debt" issued by the company.

The inability to reasonably define debt and the associated debt interest payments for a bank or depository institution can have a significant impact on the company's WACC, thereby potentially skewing the firm fair value estimation.

An illustrative example would be to assume that all interest-bearing deposits for a bank or depository institution were classified as company debt. This assumption would result in a company cost of debt that would be unrealistically low, likely leading to an unrealistically low estimated company WACC.

The reduced WACC would thereby inflate the firm fair value in the application of the DCF method. For these reasons, using CFF as an economic earnings measurement in estimating the fair value of a bank or depository institution is impractical.

As an alternative to CFF, the valuation analyst may decide to value the equity of a bank or depository institution. The equity of a bank or depository institution can be valued directly by using CFE as the earnings measurement and discounting the CFE at the company's cost of equity.

CFE is defined as the cash flow available to the firm's common stockholders once operating expenses (including taxes), expenditures needed to sustain the firm's productive capacity, and payments to (and receipts from) debt holders are accounted for, as presented below:

  Net income
+ Noncash charges
– Investments in fixed capital
– Investments in working capital
– Net new borrowing
= Cash flow to equity

As presented above, the formula for CFE begins with net income and is adjusted to arrive at the cash flow available to the firm's common stockholders. Similar to the calculation of CFF, noncash charges are added back to net income, while adjustments are made to subtract investments in fixed capital, investments in working capital, and net new debt from net income.

Unlike CFF, however, CFE does not require an adjustment for interest expense, as it is only attempting to calculate the cash flow available to the firm's equity shareholders.

As presented in *Valuing Financial Service Firms*, by Aswath Damodaran, professor of finance at the New York University Leonard N. Stern School of Business:

> The basic principles of valuation apply just as much for financial service firms as they do for other firms. There are, however, a few aspects relating to financial service firms that can affect how they are valued. The first is that debt, for a financial service firm, is difficult to define and measure, making it difficult to estimate firm value or costs of

capital. Consequently, it is far easier to value the equity directly in a financial service firm, by discounting cash flows to equity at the cost of equity.[5]

While there exists additional complexities related to the estimation of the appropriate investment in working capital included in the bank or depository institution estimated CFE, these complexities are beyond the scope of this discussion.

It is clear, however, that the valuation analyst should consider using CFE when applying the DCF method to estimate the fair value of a bank or depository institution.

The Dividend Discount Model

With some of the difficulty in accurately estimating the free cash flow of banks and depository institutions, the valuation analyst may consider the application of the dividend discount method (DDM) as an alternative to the standard DCF method.

The DDM uses the firm's dividends as a proxy for free cash flow, and discounts the dividends at the appropriate cost of equity.

The basic DDM discounts forecasted firm dividends to present value, resulting in an estimated intrinsic value contribution to the firm's shareholders. In this DDM, future dividends are assumed to be the earnings measurement to equity holders of the firm (estimated into perpetuity), and are discounted at the appropriate cost of equity.

This basic DDM formula is presented below:

$$\sum_{t=1}^{t=\infty} \frac{Div_t}{(1+K_e)^t}$$

More commonly, this basic model is split into two periods (as presented below):

1. A finite period covering future estimated dividends at a high rate of growth (g_S)
2. An infinite terminal value calculation based on a steady rate of growth (g_L) which should approximate nominal gross domestic product growth (i.e., terminal growth)

This general two-stage DDM formula is presented below:

$$\sum_{t=1}^{n} \frac{D_0\,(1+g_S)^t}{(1+K_e)^t} + \frac{D_0 \times (1+g_S)^n \times (1+g_L)}{(1+K_e)^n \times (K_e - g_L)}$$

Banks and depository institutions may be considered an appropriate candidate for the application of the DDM due to:

1. their well established and mature industry, which allows for a higher degree of confidence in estimating long-term growth rates;
2. the high correlation between past earnings growth and expected future earnings growth when compared to other companies and industries; and
3. their long, consistent history of paying dividends.

These characteristics of banks and depository institutions are particularly important in the application of the DDM, primarily because the DDM implicitly assumes that the dividends being paid are not only reasonable, but sustainable over the long term (i.e., into perpetuity).

One caveat to the application of the DDM in estimating the fair value of a bank or depository institution is the industry regulatory capital requirements and their subsequent effect on a company's payout ratio. The impact of the current regulatory capital requirements is important because they can limit the assumptions within the DDM.

Banks and depository institutions should have adequate capital on hand in order to meet anticipated customer deposit withdrawals—a capital cushion that is large enough, as a percentage of assets, to meet anticipated losses on loans and issued securities.

The regulatory capital adequacy ratios for which banks must comply influence an already significant trade-off in the industry—deciding between paying dividends and investing in future growth. As is widely known, companies that pay out their earnings as dividends forgo reinvestment in their company, and may become less competitive in the future as a result.

Increasingly stringent regulatory capital requirements restrict the amount of capital available to both the firm and the stakeholders, which decreases the company's expected future growth and/or competitiveness within the market.

The Bank and Depository Institution Industry/Regulatory Environment

The subject company industry can play a significant role in estimating appropriate assumptions that will be utilized in a DCF method or DDM fair value calculation.

In estimating the fair value of a bank or depository institution in a shareholder appraisal action,

the industry, and specifically the regulatory requirements, should be considered by the valuation analyst when applying the DCF method or the DDM.

In applying the DCF method, the valuation analyst may assume that the estimated future earnings will eventually stabilize. These long-term stabilized future earnings can then be capitalized as an annuity in perpetuity and discounted back to the valuation date.

Generally, the value of the long-term stabilized earnings is labeled as the residual value, reversion value, or terminal value (TV).

There are many issues that a valuation analyst may consider in estimating the future earnings of a business and in estimating an appropriate present value discount rate for a business. However, it is important that the valuation analysis address the subject company industry when applying the DCF method.

Specifically, the subject company industry is important in (1) assessing the reasonableness of company management-prepared projections and (2) estimating the appropriate long-term growth rate used in the TV calculation.

The Court has a history of addressing subject company industry-related issues within a shareholder appraisal action context, specifically the importance of analyzing the subject industry in regard to:

1. company management-prepared financial projections and
2. the estimation of the long-term growth rate applied in a TV calculation.

The following two sections highlight several recent Court opinions that address subject company industry-related issues within the context of an appraisal action.

While the Court decisions are not related to the bank or depository institution industry, they may provide meaningful guidance for the valuation analyst in regards to the proper consideration of the subject company industry when applying the DCF method in a shareholder appraisal action.

Industry Consideration—Management Projections

Based on historical and recent opinions, the Court expects the valuation analyst to perform appropriate due diligence with regard to the subject company industry, including as it relates to the reasonableness of management-prepared projections when applying the DCF method.

The valuation analyst may review management projections and confirm that the assumptions on which the projections are based are reasonable and appropriate given the historical, current, and future outlook of the subject company industry.

As explained by the Court *In re John Q. Hammons Hotels Inc. Shareholder Litigation*:

> In this case, it is undisputed that JQH operated in a very competitive **industry** [emphasis added]—the hotel business. JQH had no competitive advantages, such as brand names or proprietary technology. Worse still, a large portion of its portfolio is located in secondary and tertiary markets, which have lower barriers to entry than primary markets. Hotels in secondary and tertiary markets face significant competition because of the lower barriers to entry. . . . And JQH's hotels were even subject to competition from their own franchisors in many of the markets where JQH operated. Dr. Kursh's expert report failed to take into account some of these factors affecting JQH, and his report is significantly impaired as a result.[6]

The above decision highlights the fact that by neglecting to appropriately consider the subject company industry, the valuation analyst may be at risk of having the Court dismiss the opinion of value entirely.

In explaining the decision to disallow the application of the DCF method in *Doft & Co., et al., v. Travelocity.com, Inc., et al.*, the Court relied on, in part, the state of the subject company industry as testified to by Anwar Zakkour, a Solomon Smith Barney managing director:

> Q. Did Salomon Smith Barney prepare a discounted cash flow analysis of Travelocity in connection with this transaction?
>
> A. Absolutely not.
>
> Q. Why was no discounted cash flow analysis prepared in connection with this transaction?
>
> A. Because this was an **industry** [emphasis added] that was in flux. And the management team itself, which should have been the team that was most able to put together a set of projections, would have told you it was virtually impossible to predict the performance of this company into any sort of reasonable future term. And they in fact had very little confidence with even their 2002 forecast numbers because of that.
>
> September 11th didn't help the pace of migration from off-line to online. It didn't help. The airlines being very focused on cutting their distribution costs didn't help. These were all things that were happening real time. Travelocity going from being the number one player to being very unfavorably compared to Expedia and certainly losing its number one position to them in a very short time didn't help. These are all things that support that. And other than maybe God himself, I suspect nobody could really predict what this business is going to do in the next five years.[7]

The Court further explains in *Doft & Co., et al., v. Travelocity.com, Inc., et al.*:

> For these reasons, the court reluctantly concludes that it cannot properly rely on either party's DCF valuation. The goal of the DCF method of valuation is to value the future cash flows. Here, the record clearly shows that, in the absence of reasonably reliable contemporaneous projections, the degree of speculation and uncertainty characterizing the future prospects of Travelocity and the **industry in which it operates** [emphasis added] make a DCF analysis of marginal utility as a valuation technique in this case.[8]

Industry Consideration—Estimated Long-Term Growth Rate in TV Calculation

The Court has also opined on subject company industry consideration when estimating the appropriate long-term growth rate to use in a TV calculation in the DCF method performed in a shareholder appraisal action context.

For example, the Court explains in *Towerview, LLC, et al., v. Cox Radio, Inc.*:

> As noted, the rate of inflation generally is the "floor for a terminal value." "Generally, once an **industry** [emphasis added] has matured, a company will grow at a steady rate that is roughly equal to the rate of nominal GDP growth." Some experts maintain that "the terminal growth rate should never be higher than the expected long-term nominal growth rate of the general economy, which includes both inflation and real growth. Moreover, both experts in this case acknowledged that the expected long-term inflation rate in 2009 was 2%–2.5%. There also was some evidence that the expected rate of real GDP growth was between 2.5% and 2.7%, but this evidence was not particularly reliable. I find that the radio **industry** [emphasis added] is a mature industry and that CXR was a solidly profitable company. Thus, a long-term growth rate at least equal to expected inflation is appropriate here.[9]

In order to appropriately estimate the long-term growth rate to be used in the TV calculation, the Court's decision implies that the valuation analyst may address (1) the profitability of the subject company and (2) the maturity stage of the industry (i.e., the current and projected profitability of the subject company industry).

As further opined by the Court in *Merion Capital, L.P., et al., v. 3M Cogent, Inc.*:

> Relying on historical GDP and inflation data, economic analysts projections, and the growth prospects of the biometrics **industry** [emphasis added], Bailey selected a perpetuity growth rate of 4.5%. The Gordian Experts, on the other hand, used a range of growth rates between 2% and 5%, and implicitly selected the midpoint of 3.5%. The Gordian Experts, however, provided no analysis or explanation in support of the number they chose for the terminal growth rate. Because Bailey was the only expert who sought to justify his conclusions, and his conclusion is within the range of rates identified by Respondent's expert and appears to be reasonable based on the evidence, I adopt Bailey's estimate of a 4.5% perpetuity growth rate.[10]

As opined by the Court in the above shareholder appraisal action decisions, when applying the DCF method, the state of the subject company industry may be considered when (1) assessing the reasonableness of company management-prepared projections and (2) estimating the appropriate long-term growth rate to be used in a TV calculation.

Further, neglecting to appropriately consider the subject industry may lead to the Court dismissing the valuation analyst opinion in its entirety.

In regards to the bank and depository institution industry, it may be helpful to understand the regulatory requirements in place as of the valuation date. Specifically, a bank or depository institution return on equity capital will be estimated based on:

1. the company's business choices and
2. regulatory restrictions in place as of the valuation date.

Therefore it may be helpful to understand the pertinent regulations when applying the DCF in a bank or depository appraisal action. This is because any changes in the regulatory environment can result in large shifts in the estimated fair value of the company.

Summary and Conclusion

In a shareholder appraisal action, a noncontrolling shareholder possesses the right to object to certain extraordinary actions taken by the corporation, such as a merger. The appraisal remedy requires the corporation to repurchase the shareholder's stock at a price equivalent to the corporation's value immediately prior to the corporate action.

A bank or depository institution can be the subject of a dissenting shareholder appraisal rights action, just like any other corporation. However, in the estimation of the fair value of a bank or depository institution, the valuation analyst should address some of their individual operational traits as compared to many other corporations.

The Delaware Court of Chancery is generally regarded as an important forum for ruling on dispute litigation involving matters related to shareholder dissent. Of the several categories of shareholder disputes, this discussion focused on dissenting shareholder appraisal rights actions specifically related to banks and depository institutions.

As proffered by the Court, the DCF method is one method of estimating the fair value of a corporation within an appraisal action context. However, in applying the DCF to a bank or depository institution fair value analysis, the valuation analyst may consider the unique operating characteristics associated with the industry in estimating the appropriate earnings measurement (i.e., CFE rather than CFF).

Further, when applying the DCF method in a dissenting shareholder appraisal action, the valuation analyst may consider the subject company industry, and specifically the regulatory environment in which the bank or depository institution operates.

Based on guidance from the Chancery Court, when applying the DCF method, the subject company industry may be considered when (1) assessing the reasonableness of company management-prepared projections and (2) estimating the appropriate long-term growth rate to be utilized in a terminal value calculation.

Neglecting to address the subject company industry may lead to dismissal of the valuation analyst opinion in its entirety.

Notes:

1. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. Ch. 1983)
2. Crescent/Mach I Partnership, L.P. v. Turner, No. Civ.A 17455-VCN, Civ.A. 17711-VCN, 2007 WL 1342263 at *9 (Del. Ch. May 2, 2007).
3. Cede & Co. v. JRC Acquisition Corp., No. Civ.A. 18648-NC, 2004 WL 286963, at *2 (Del. Ch. Feb. 10, 2004).
4. Union Illinois v. Union Financial Group, 847 A.2d 340 (Del. Ch. 2004)
5. Aswath Damodaran, "Valuing Financial Service Firms," whitepaper (April 2009), http://www.stern.nyu.edu/~adamodar/pdfiles/papers/finfirm09.pdf (accessed 9/4/15).
6. In re John Q. Hammons Hotels Inc. Shareholder Litigation, No. 758-CC, 2011 WL 227634 (Del. Ch. Jan. 14, 2011).
7. Doft & Co. v. Travelocity.com, Inc., No. Civ.A. 19734, 2004 WL 1152338 (Del. Ch. May 21, 2004).
8. *Id*.
9. Towerview, LLC v. Cox Radio, Inc., C.A. No. 4809–VCP, 2013 WL 3316186 (Del. Ch. June 28, 2013).
10. Merion Capital, L.P., v. 3M Cogent, Inc., No. 6247–VCP, 2013 WL 3793896 (Del. Ch. July 8, 2013).

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Insights Wins the APEX 2015 Publication of Excellence Awards Competition

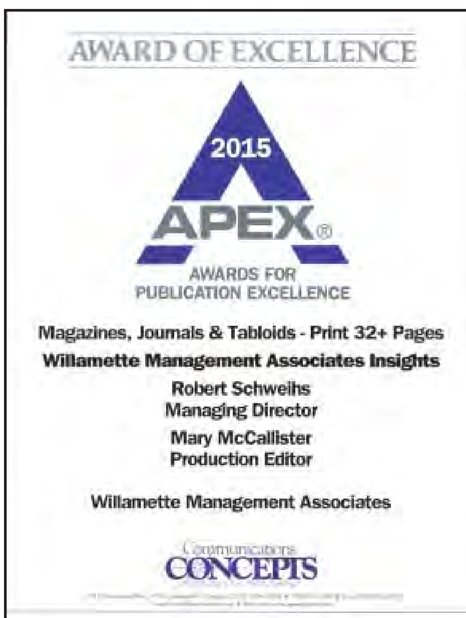
Introduction

We are proud to announce that the quarterly business valuation journal *Insights*, published by Willamette Management Associates, received a publication excellence award in the 2015 APEX Award of Excellence competition.

This is the sixth year in a row that the thought leadership in *Insights* has been recognized with an Apex Award of Publication Excellence.

APEX Awards for Publication Excellence

The APEX Awards for Publication Excellence are presented based on an annual competition for writers, editors, publication staffs, and business and nonprofit organization communicators. International in scope, the APEX competition recognizes outstanding publications ranging from institutional newsletters and magazines to corporate annual reports, brochures, and websites.



There were nearly 1,900 entries in the APEX 27th annual awards program. *Insights* was a winner in the Magazine & Journal Print category of the 2015 annual APEX award of excellence competition.

"We are honored to receive the APEX Publication of Excellence Award for our quarterly business valuation journal *Insights*," said firm managing director Robert Reilly. "This is the sixth year in a row that we have received the APEX recognition for publication excellence in the Magazine & Journal Print category. This award motivates us to continue to provide thought leadership in a journal that focuses on the business valuation, forensic analysis, and financial opinion disciplines."

Each quarterly issue of *Insights* presents current thought leadership related to one or more of our firm's financial advisory services disciplines. These professional disciplines include economic damages measurement and lost profits analysis, business and security valuation, intangible asset and intellectual property analysis, intercompany transfer price analysis, bankruptcy and reorganization analysis, forensic accounting and expert testimony, and corporate transaction opinion services.

Each quarterly *Insights* issue typically includes about 8 to 10 discussions. In each 96-page issue, about half of the *Insights* discussions are written by Willamette Management Associates authors. And, about half of the *Insights* discussions in each issue are authored by lawyers, bankers, accountants, or academics who are not associated with Willamette Management Associates.

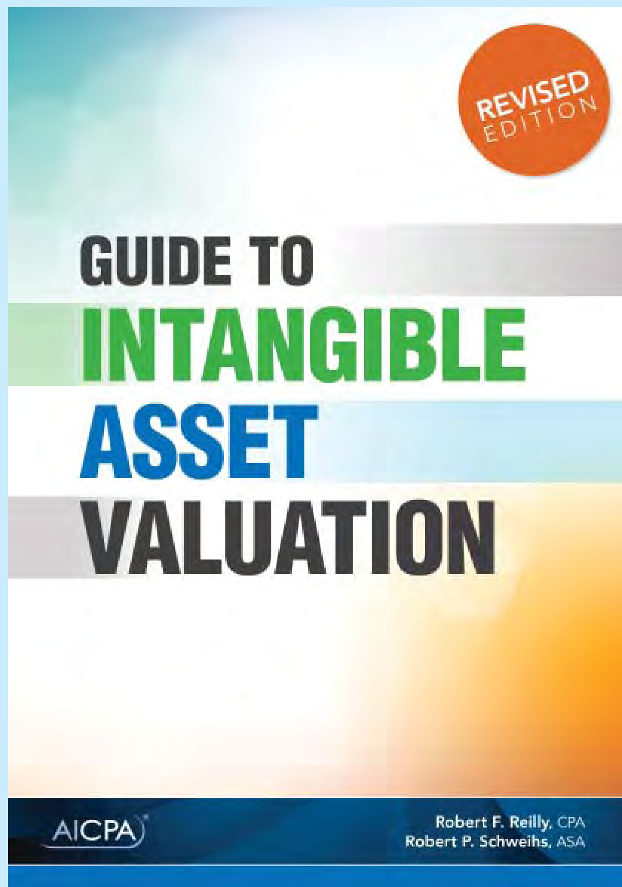
About Willamette Management Associates

Founded in 1969, Willamette Management Associates provides thought leadership in its business valuation, forensic analysis, and financial opinion services. Our clients range from substantial family-owned companies to Fortune 500 corporations. And, our clients also include financial institutions, the accounting and audit profession, the legal community, and government and regulatory agencies.

We are pleased to announce the 2014 hardback Revised Edition of . . .

Guide to Intangible Asset Valuation

by Robert F. Reilly and Robert P. Schweihs



This 745-page book, originally published in 2013 by the American Institute of Certified Public Accountants, has been improved! The book, now in hardback, explores the disciplines of intangible asset valuation, economic damages, and transfer price analysis. *Guide to Intangible Asset Valuation* examines the economic attributes and the economic influences that create, monetize, and transfer the value of intangible assets.

Robert Reilly and Bob Schweihs, Willamette Management Associates managing directors, discuss such topics as:

- Identifying intangible assets and intellectual property
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- Generally accepted valuation approaches, methods, and procedures
- Economic damages due diligence procedures and measurement methods
- Allowable intercompany transfer price analysis methods
- Intangible asset fair value accounting valuation issues
- Valuation of specific types of intangible assets (e.g., intellectual property, contract-related intangible assets, and goodwill)

Illustrative examples are provided throughout the book, and detailed examples are presented for each generally accepted (cost, market, and income) valuation approach.

Who Would Benefit from This Book

- Litigation counsel involved in tort or breach of contract matters
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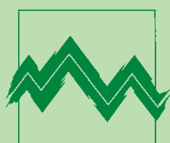

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Guide to Intangible Asset Valuation

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Thought Leadership

Rescissory Damages in the Delaware Court: A Viable Remedy for Stockholders or Just an Illusion?

Jennifer Sarnelli, Esq.

Seeking a full and fair recovery for stockholders who have been harmed by a board of directors that has breached its duties is the paramount goal in Delaware stockholder actions. Rescissory damages have often been alluded to as a possible remedy to resolve these breaches, but they are rarely granted. Understanding the pitfalls of achieving rescissory damages can lead to larger recoveries for stockholders.

Introduction

While pled in nearly every stockholder class action, rescissory damages remain an elusive remedy in the Delaware courts. "Delaware courts have been 'extremely reluctant' to award rescissory damages"—and particularly in the transactional context.[1]

Nonetheless when the only alternative remedy would be to unwind a consummated transaction, the Delaware courts recognize that rescissory damages are a more practical alternative. And out-of-pocket, quasi-appraisal damages are not always adequate to properly compensate stockholders, particularly where fraud or self-dealing is afoot.

However, despite significant dicta espousing the benefits of these damages, they are rarely realized by stockholders.

The History of Rescissory Damages

Rescissory damages are routed in the federal securities laws. In federal securities fraud actions, rescissory damages are available in addition to out-of-pocket losses when the price of the stock appreciated after the sale and the buyer profited.

This concept has carried over to stockholder challenges of merger transactions in the Delaware courts.

Most actions that achieve a monetary benefit for stockholders aggrieved by a disloyal board are in the form of compensatory or actual damages. Compensatory damages are designed to compensate a plaintiff (or class of stockholders) for an actual "out-of-pocket" loss caused by the defendants.

When the Delaware courts find that a merger is consummated at an unfair price, stockholders are entitled to the fair value of their stocks (minus any amount already received in the merger). To come up with these actual damages, the court looks to the same types of methodologies used in appraisal actions. The court also may rely significantly on the expert reports of valuation analysts.

Rescissory damages are also a possible remedy for a breach of the duty of loyalty—including cases where directors of a corporation are engaged in self-dealing, putting their personal interests above those of the stockholders. These damages are an exception to the typical model of actual out-of-pocket losses.

Such damages are considered to be extraordinary. This is because, unlike actual damages, these damages are measured after a merger is completed.

Because of the extraordinary nature of these damages, they are only considered in connection with a loyalty breach and not a breach of the duty of care.

> **"When the rescission of a consummated transaction would be the best result for stockholders, but it is not feasible . . . , rescissory damages provide the best possible solution."**

Further, rescissory damages are not available for disclosure violations in a short form merger "because under Section 253 a short form merger becomes effective before any disclosures to the minority stockholders are made."[2]

When Are Rescissory Damages Available to Stockholders?

When the rescission of a consummated transaction would be the best result for stockholders, but it is not feasible because of the passage of time or the merging of corporate assets, then rescissory damages provide the best possible solution.

"At the most general level, this remedy is premised upon the idea that (1) the transaction whereby the party gave up an asset was wrongful in some way and (2) the nature of the wrong perpetrated is such that plaintiff is entitled to more than his 'out-of-pocket' harm, as measured by the market value of the asset at or around the time of the wrong."[3]

Putting a stockholder in the position they would have been in if a fiduciary had not breached their duty of loyalty is often an improbable task. For example, once a merger is consummated, it is all but impossible for the court to order the companies to be split back in two. In circumstances such as these, rescissory damages can provide an equitable substitute.

Rescissory damages seek:

> (i) to restore the plaintiff-beneficiary to the position it could have been in had the plaintiff or a faithful fiduciary exercised control over the property in the interim and (ii) to force the defendant to disgorge profits that the defendant may have achieved through the wrongful retention of the plaintiff's property.[4]

But the Delaware courts have repeatedly rejected claims of rescissory damages based on justifications such as speculation, lack of causation, the complexity of crafting a rescissory remedy, and delay.

In *Universal Enterprises*, for example, the court rejected a rescissory damages calculation on causation grounds for failing to address the "manifold independent causes" of damages.[5] The court found that plaintiffs failed to prove that the rescissory damages sought were causally related to the fraud alleged.

In so holding, the court noted that the expert report failed to recognize other variables that may have impacted the damages aside from the alleged fraud—such as changing economic markets. *Universal Enterprises* is a clear example of the need to obtain a strong expert report in order to make a case to recover these exceptional damages.

Similarly, in *Sunbelt*,[6] the court refused to grant rescissory damages based on "significant issues related to complexity and implementation." The court found that engaging in a valuation analysis, selecting the appropriate valuation metrics and the appropriate time period under which to view these measures would "pose an issue of arbitrariness." Thus the practical difficulties in reaching a rescissory damage figure precluded one from being awarded.

And in *Weinberger*,[7] the court ultimately determined rescissory damages were inappropriate "because of the speculative nature of the offered proof."

Still these damages are often sought and have provided a meaningful benefit when plaintiffs are able to present a definitive basis for them and an explicit plan on the amounts that should be awarded.

In *Lynch II*, the seminal case regarding rescissory damages, the Delaware Supreme Court explained that it could provide a fair result for stockholders without issuing a recession order.[8]

In *Lynch II*, a proposed class action on behalf of TransOcean Oil, Inc. ("TransOcean"), stockholders challenged a tender offer by the company's controlling stockholder, Vickers Energy Group ("Vickers"), alleging that the directors had breached their fiduciary duties to stockholders. Vickers, which held 53.5 percent of the TransOcean common stock, made a tender offer to purchase the company for $12 cash per share.

Stockholders alleged that defendants did not make full and frank disclosures in connection with the tender offer and that Vickers had coerced stockholders to tender their shares.

The court entered judgment for the plaintiffs, setting forth a bright line rule that a duty of candor

fell within a board's fiduciary duties. The Chancery Court, however, found that the plaintiffs had failed to establish damages.

In reversing the Chancery Court ruling, the *Lynch II* court noted that rescission is the preferable remedy. However, when that is not possible, the court held that a fair result could be "accomplished by ordering damages which are the monetary equivalent of rescission . . . [which] is a norm applied when the equitable remedy of rescission is impractical."[9]

Lynch II determined that in order to make a stockholder whole, "the proper measure of damages should be the equivalent value of the stock at the time of resale or at the time of judgment."[10]

Relying on precedent outside Delaware, the *Lynch II* court determined that the defendants would be required to "pay rescissory damages to plaintiffs measured by the equivalent value of the [company's] stock at the time of judgment."[11]

Just a year later, the Delaware Supreme Court spoke again on the topic of rescissory damages and reversed the holding in *Lynch II* "to the extent that . . . [it] purport[ed] to limit the Chancellor's discretion to a single remedial formula for monetary damages in a cash-out merger."[12]

In *Weinberger*, the former stockholders of UOP, Inc. ("UOP") alleged that the majority stockholder, The Signal Companies, Inc. ("Signal"), had breached its fiduciary duties in connection with a cash-out merger. Signal had initially become the company's controlling stockholder through a tender offer wherein it acquired 50.5 percent of the company's common stock.

Three years after it took a controlling stake in the UOP, Signal decided to seek to squeeze out the noncontrolling stockholders. Despite two of UOP's own directors issuing a feasibility study for Signal that concluded that it would be a good investment to purchase the outstanding shares of UOP for $24 per share, Signal chose not to share this information with the company's noncontrolling stockholders or the other members of the UOP board.

Signal ultimately issued a tender for $21 per share which the board recommended the noncontrolling stockholders accept. A lawsuit ensued.

In reversing a Chancery Court ruling for the defendants, the Delaware Supreme Court held that defendants had breached their duty of disclosure and stockholders were entitled to damages including possible rescissory damages.

The *Weinberger* court was the first to establish that the court should take a "more liberal approach [which] must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court."[13]

Because the transaction was "too involved to undue" the *Weinberger* court remanded to allow the Chancery Court to consider rescissory damages in addition to considering quasi-appraisal damages.

While the Chancery Court ultimately chose not to grant rescissory damages on remand, the *Weinberger* court opened the door for the Chancery Court to take a more equitable view of the damages available to stockholders once a merger is consummated and rescission becomes impracticable.

With this equitable approach established, the Chancery Court again looked at the availability of rescissory damages in connection with a cash-out merger.

In *Technicolor*,[14] Cinerama, Inc. ("Cinerama"), the holder of 4.4 percent of Technicolor's common stock, filed an action challenging a tender offer and second step merger made by a subsidiary of MacAndrews and Forbes Group, Inc. ("MacAndrews") for $23 per share in cash.

Cinerama alleged that the Technicolor board breached its duty of loyalty to its stockholders in connection with its negotiations with MacAndrews and Ronald Pearlman (the MacAndrews controlling stockholder).

The *Technicolor* court opined that there were two primary types of rescissory damages: "The first grows out of, and is closely connected to, restitutionary relief. The second theory (and the more prominent one) employs a liberal application of the compensatory theory of damages against trustees who commit egregious breaches of the express terms of a trust or who self-deal."[15]

Under the first theory, which is the theory that was espoused in *Lynch II*, the court is seeking to prevent unjust enrichment by a self-interested fiduciary. The second theory is grounded in trust law. When a fiduciary is not interested in the transaction, but rather, has breached its duty to stockholders by not being adequately informed, these trust law damage concepts come into play.[16]

The *Technicolor* court found that even under the "trust theory" of rescissory damages, that plaintiffs must present evidence that the directors were "actually motivated by interests other than those of the shareholders." The court recognized that this

position would "arguably be a departure from the broad view of a trustee's duty of loyalty . . . it is [] consistent with the core idea of these, and other trust cases."[17]

Laches will also impede awarding rescissory damages. The principal of equity will estop an award of rescissory damages when plaintiffs excessively delay in seeking rescissory damages.[18]

The *Gaffin* court explained that a delay in seeking rescissory damages constitutes waiver by plaintiffs and "there is no requirement that the defendant show prejudice from the delay."[19]

The court reasoned that if a plaintiff was permitted to "opportunistically wait[] to see whether the defendants achieve an increase in the value of the company above its likely appraisal value, before deciding to assert a claim for rescission, or its monetary equivalent, rescissory damages."[20]

The Delaware courts have continued to follow this model. Most recently, in *Southern Peru*,[21] Chancellor Strine held that "[r]escissory damages are the economic equivalent of rescission and therefore if rescission itself is unwarranted because of the plaintiff's delay, so are rescissory damages."

This conclusion was affirmed by the Delaware Supreme Court, wherein the court noted "that the Court of Chancery properly exercised its broad historic discretionary powers in fashioning a remedy and making its award of damages."[22]

Nevertheless, the passage of time alone is not an impediment in granting rescissory damages. The Delaware courts have accepted rescissory damages as potentially appropriate in cases where a transaction has closed years earlier.[23]

The Delaware Supreme Court in *Technicolor* found that rescissory damages were an available remedy for a transaction that had closed 10 years previously. Similarly, the *Lynch II* court held in 1981 that rescissory damages should be awarded for a transaction that closed in 1974, seven years earlier.

"The passage of time of course plays a role in the availability of rescissory damages, but less so for rescissory damages than with true rescission. This is because the passage of time may be what renders rescission impractical and requires the deployment of rescissory damages as the functional equivalent."[24]

Recently, the Court of Chancery looked at the availability of rescissory damages in connection with a controlling shareholder buyout transaction in *Orchard Enterprises*. The Orchard Enterprises, Inc. ("Orchard") was taken private by its controlling stockholder, Dimensional Associates LLC ("Dimensional") in a cash-out merger.

Dimensional controlled Orchard, owning 42.5 percent of the company's common stock and 99 percent of the company's preferred stock.

Under the terms of the preferred stock agreement, Dimensional was to be provided with a $25 million liquidation preference under certain circumstances.

Specifically, the Certificate of Designations, which set forth the terms of the liquidation preference, required the payment of $25 million to Dimensional if the company was dissolved, if there was a sale of all or substantially all of Orchard's assets leading to a liquidation of the company, or if control of the company was sold to an "unrelated third party."

The going-private transaction did not trigger the liquidation preference because there was no change in control. Nevertheless, Dimensional was credited with the $25 million liquidation preference in the merger and defendants made repeated misrepresentations that Dimensional was entitled this credit under the terms of the Certificate of Designations. Further, in confirming the fairness of the buyout price to stockholders, the company's financial adviser considered the $25 million preference as being triggered based on the instruction of the board of directors.

The cash-out merger permitted Dimensional both to be credited with the full value of the $25 million liquidation preference *and* to keep all of its preferred stock. The unfairness of the cash-out merger in crediting Dimensional with the $25 million preference was confirmed by Dimensional turning around just 19 months later and merging Orchard with a Sony Music entity ("Sony")—and getting paid the $25 million liquidation preference again.

Plaintiffs alleged that by considering the $25 million liquidation preference as being triggered in connection with opining on the fairness of the price paid to stockholders, making material misrepresentations to stockholders, and allowing Dimensional to both be credited with the liquidation preference and keep the preferred shares, the board and Dimensional had breached their duty of loyalty to stockholders.

The *Orchard* action sought both traditional and rescissory damages. In a lengthy decision on the parties competing motions for summary judgment, the court granted the plaintiffs' motion in part finding that (1) the entire fairness standard of review was applicable and that it was defendants' burden to show the transaction was entirely fair as to price and process and (2) the defendants had made a material misrepresentation as a matter of law in the meeting notice provided to stockholders regarding the application of the liquidation preference.

Finally, the court found not only that rescissory damages were an available remedy, but also that those damages could be coupled with additional damages. In reaching its conclusion, the Chancery Court explained the history of rescissory damages in the Delaware courts.

The *Orchard* Court held that:

> [a]n award of rescissory damages is one form of relief that could be imposed if the merger is found not to be entirely fair and if one or more of the defendants are found to have violated their fiduciary duty of loyalty.
>
> Any award of rescissory damages only would be imposed on those fiduciaries who committed a loyalty breach. If appropriate, rescissory damages could be crafted using the Orchard/Sony Merger as the point of resale.[25]

Despite the finding that rescissory damages were potentially available at summary judgment, the plaintiffs, knowing that the Delaware courts have so rarely granted rescissory damages, chose to settle the action. The nature of the rescissory damages that were being sought was based on the value of the subsequent Sony/Orchard merger.

Finding support for ultimately awarding rescissory damages is rare enough in Delaware, but rarer still is finding support for the award of rescissory damages based on the value of a subsequent transaction or increased value of a company.

Aside from *Lynch II*—decided over 30 years ago—there does not seem to be a single opinion granting such damages under these circumstances. The settlement provided stockholders 195 percent more than initially received in the underlying transaction and accounted for elements of what the plaintiffs intended to seek in rescissory damages.

Conclusion

While the Delaware courts have repeatedly made clear that rescissory damages are available, in application they are rarely seen.

Avoiding delay and presenting a clear plan on how these damages can be calculated are, in this author's view, critical components to achieving this remarkable result for stockholders in connection with an adjudicated breach of the duty of loyalty.

Notes:

1. Universal Enterp. Grp., L.P. v. Duncan Petrol. Corp., C.A. No. 4948, 2013 WL 3353743, at *16 (Del. Ch. July 1, 2013).
2. Berger v. Pubco Corp., 976 A.2d 132, 136 (Del. 2009).
3. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1144 (Del. Ch. 1994) *aff'd*, 663 A.2d 1156 (Del. 1995).
4. In re Orchard Enterp., Inc. S'holder Litig., 88 A.3d 1, 39 (Del. Ch. 2014).
5. Universal Enterp. Grp., 2013 WL 3353743, at *16.
6. In re Sunbelt Bvg. Corp. S'holder Litig., C.A. No. 16089–CC, 2010 WL 26539, at *14 (Del. Ch. Jan. 5, 2010)
7. Weinberger v. UOP, Inc., C.A. No. 5642, 1985 WL 11546, at *7 (Del. Ch., Jan. 30, 1985)
8. Lynch v. Vickers Energy Corp., 429 A.2d 497 (Del. 1981) ("Lynch II") *overruled on other grounds by* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).
9. *Id.* at 501.
10. *Id.* quoting 12A Fletcher Cyclopedia Corporations (Perm. Ed.) § 5598.
11. *Id.* at 502-503; *overruled by* Weinberger, 457 A.2d 701.
12. Weinberger, 457 A.2d at 714.
13. *Id.* at 713.
14. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1144-45 (Del. Ch. 1994) *aff'd*, 663 A.2d 1156 (Del. 1995)
15. *Id.*
16. *Id.* at 1146.
17. *Id.* at 1149.
18. Gaffin v. Teledyne, Inc., No. CIV. A. 5786, 1990 WL 195914, at *18 (Del. Ch. Dec. 4, 1990) *aff'd in part, rev'd in part*, 611 A.2d 467 (Del. 1992).
19. *Id.*
20. Ryan v. Tad's Enterprises, Inc., 709 A.2d 682, 699 (Del. Ch. 1996) *aff'd*, 693 A.2d 1082 (Del. 1997).
21. In re S. Peru Copper Corp. S'holder Derivative Litig., 52 A.3d 761, 815 (Del. Ch. 2011)
22. Americas Mining Corp. v. Theriault, 51 A.3d 1213, 1252 (Del. 2012)
23. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 372 (Del. 1993) *decision modified on reargument*, 636 A.2d 956 (Del. 1994).
24. In re Orchard Enterprises, Inc. Stockholder Litig., 88 A.3d 1, 41 (Del. Ch. 2014).
25. *Id.* at 41-42.

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Best Practices to Avoid Intrafamily Transaction Shareholder Litigation

Katherine A. Gilbert and Weston C. Kirk

Avoiding, or at least minimizing, the potential for intrafamily shareholder litigation is constantly on the minds of wealth planning advisers. Wealth planning advisers include trust and estate attorneys, accountants, financial advisers, bankers, and valuation analysts. This discussion addresses the best practices for high net worth families to avoid such intrafamily litigation. Such best practices may be implemented both by the high net worth family members and by their wealth planning advisers.

Introduction

Significant wealth (particularly in the form of closely held business ownership) creates a number of concerns for families. One of the most important concerns is how to properly transition wealth from the current generation to the next generation—not only in a tax-effective way, but also in a cordial manner among the heirs.

Orchestrating and managing intergenerational wealth transfers require a delicate balance among:

1. the timing of the transfer,
2. the amount of the transfer, and
3. the overall cost to effectuate the transfer.

Wealth planning becomes a major time investment, and it can become expensive. This statement is especially true when the intergenerational wealth transfer program is executed incorrectly.

Additionally, wealth transfers, specifically intrafamily transfers, can cause tension between family members and other family-owned business shareholders. This strain can often lead to unnecessary shareholder litigation, both intrafamily and otherwise.

This discussion addresses the best practices prior to, during, and after intrafamily transactions to help avoid unnecessary shareholder litigation. This discussion predominately focuses on issues that affect valuation, but it will extend to succession planning, legal agreement documentation, transaction processes, and corporate planning.

Finally, two recent judicial decisions are used to illustrate the importance of implementing some or all of these best practices.

Laying the Best Foundation for Intrafamily Transactions

Intrafamily transactions are transfers, either by sale or gift, between family members. One of the most common intrafamily transactions is the gift of shares of the family-owned business from the parent generation to the children generation.

Although each situation is unique, well thought out estate planning takes time and effort. With most family-owned businesses, estate planners will effectuate intrafamily transactions in small pieces until:

1. the family business is in the hands of the next generation (or generations) and
2. the parents retain little to no residual interest.

Well orchestrated estate planning requires specialists in the areas of trusts and estates, tax accounting, valuation services, and wealth planning. These advisers are usually separate and distinct

from the corporation's accountants and attorneys. This is because intrafamily transactions are complicated and require specialized skills and consistent industry exposure.

As things change from a regulatory or taxation perspective, wealth planning may be accelerated, delayed, or revised. In addition, when family situations change, intergenerational wealth planning is often altered in some fashion. Having a dedicated team of advisers in this specialized area is important for successful intrafamily transactions.

Additionally, one of the important aspects of successful intrafamily transactions is to not only have a special team of advisers, but to have professionals who are both prominent and regarded in their respective professions.

These advisers will act as long-term advisers to the family for many years, if not generations. This will ensure that the intended goals of the parents will play out according to plan, throughout the generations.

Having prominence and respect in the estate planning industry is helpful as these specialized situations require unique solutions and creative thinking.

Further, the team of advisers needs to be able to work together with the family members to accomplish their estate planning wishes. This requires consistent communication between the parties as estate planning procedures are being accomplished.

Often, annual or bi-annual meetings of these advisers take place to discuss current issues and processes. With families of high and ultra-high net worth, family offices become a component to this communication aspect and act as central hubs of information.

The family and the advisers should all understand the estate planning steps that are being made, and everyone should be in agreement concerning those procedures. These matters can be especially difficult for the next generation to understand and agree upon.

Lastly, intrafamily transactions require well thought out plans, procedures, and processes for implementation. All parties should be on board with how complicated, extensive, and expensive the implementation of certain intrafamily transactions will be.

A proper estate plan should be drafted by a trust and estate attorney and followed by the advisers, not precluding necessary changes and edits from time-to-time.

The foundation to intrafamily transactions can be summarized as follows:

- Have an organized, trusted, experienced, and long-term team of estate planning advisers.
- Communicate often with your advisory team and the next generation to ensure the goals and objectives are clear and understood.
- Draft and follow a well thought out estate plan that can be amended periodically.

Having these elements in place will ensure that the foundation of the family's estate plan is sound and most effective—both financially and procedurally.

The Valuation Analyst's Role in Intrafamily Transactions

Most people understand the roles of trust and estate attorneys, wealth advisers, asset managers, accountants, and estate planners in intrafamily transactions. The one role that is often underutilized in intrafamily transition planning is the valuation analyst.

Valuation analysts play an important role in intrafamily transactions. Not only do valuation

> "Prior to an intrafamily transaction, valuation analysts can assist in structuring a transaction that meets all parties' goals and objectives."

analysts provide autonomous and unbiased advice and valuation analysis, but they also provide fairness, expertise, and adequate disclosure documentation.

Prior to an intrafamily transaction, valuation analysts can assist in structuring a transaction that meets all parties' goals and objectives. Valuation analysts can assist legal counsel in understanding the valuation considerations and effects of changes in legal agreements and transitional documents that could affect the value of interests under proposal to be sold, gifted, or exchanged.

During an intrafamily transaction, independent valuation analysts provide unbiased advice and opinions. They can be relied on to provide their expertise and estimate of fair market value of the subject interest without unneeded bias. Potentially nonindependent and biased opinions may be provided by:

1. investment bankers;
2. other family members;
3. internal accountants;
4. anyone with a contingency fee;
5. anyone with an interest in the asset, property, or security being valued; or
6. anyone with a relationship that may be affected due to a lack of follow-through on certain client requests.

Valuation analysts may also be helpful in assisting parties in negotiation as a third party and providing adequate disclosure and other forms of documentation in related-party transactions, which may be necessary for tax filing disclosures.

After an intrafamily transaction, valuation analysts usually (and should) provide assistance in defending their analysis if the valuation is at all questioned by the Internal Revenue Service, the Department of Labor, the Department of Justice, the U.S. Securities and Exchange Commission, or any other federal agency; or if the transaction is ever litigated by another shareholder or family member.

Above all, a valuation analyst's expertise is instrumental in effectively implementing intrafamily transactions.

Best Practices

Although not representative of all examples, the following list presents "best practices" that family-owned companies should implement before, during, and after intrafamily transactions:

- Clearly written and agreed-upon estate plan
- Clearly written and agreed-upon succession plan
- Clearly written operational agreements that set forth the shareholder operational involvement in the company, including elections of board members and management
- Open access to company documents and procedures to ensure transparency between family shareholder members
- Access to regular annual shareholder meetings
- Ability for family shareholders to oversee and observe board of directors meetings
- Access to regular annual valuations by a reputable valuation firm for family shareholders to more effectively and efficiently coordinate individual estate planning objectives
- Clearly written rules and procedures of family shareholders involvement (or lack of involvement) in the company affairs, including influence on dividend distributions, selling one's interest to a third party, or registering the private company for an initial public offering
- Requirement for a certain number of years of outside experience or education/ expertise for certain management members and board roles within the company
- Requirement of an advisory board or board of directors with some (if not all) independence and that board committees would include such independent advisers (e.g., audit, compensation, and governance committees)
- Have a policy in place (1) to select directors based on experience and qualifications, (2) to vote in directors and remove directors, and (3) to periodically (e.g., annually) review directors
- Align incentive plans and policies with the efforts and work provided by each family member in the company; this should mirror compensation provided to nonfamily members (which may include long-term incentive plans, such as stock appreciation

rights, for nonshareholder management and directors)

- Defined policy for shareholder distributions and stock repurchases
- Provide within the shareholder agreements that any litigation that may take place will be through binding arbitration in one state rather than public court proceedings in various jurisdictions

Judicial Precedent Examples

There are numerous judicial decisions related to intrafamily litigation. This section takes a closer look at two cases: *Edler v. Edler*[1] and *In the Matter of Zulkofske*.[2]

Edler v. Edler

In *Edler v. Edler*, Steven and Richard Edler were brothers who co-owned Edler & Sons Trucking & Excavating, Inc., a trucking and excavating company that was originally started by their father.

Before their father retired, Steven was the father's partner while Richard was a truck driver. When the father retired, the company was reformed with Steven owning 60 percent and Richard owning 40 percent.

Over a short period of time, Steven started to oppress Richard by taking away his salary, making him an hourly employee who was required to submit time cards, and taking away his corporate check writing privilege.

Richard was also away from the business as a result of having cancer. When he tried to return to the business, his employee status was terminated, and he was replaced as corporate vice president by Steven's wife.

Richard sought judicial dissolution of the company due to Steven's oppressive conduct. The parties jointly retained a valuation analyst to calculate the fair market value of Richard's 40 percent interest.

The analyst applied the adjusted net asset value method (an asset-based approach valuation method), valued the company as a going-concern business enterprise, and applied a combined 30 percent discount for lack of control and discount for lack of marketability.[3]

The court concluded it was inequitable to apply the lack of control and lack of marketability discounts. The court recognized that a discount for lack of control discourages the equitable purpose of protecting a noncontrolling shareholder from a squeeze out.

The exclusion of Richard by Steven from the company created the same situation faced by a dissenter shareholder in a closely held corporation. The court summarized that, "[t]he shareholder not only lacks control over corporate decision making, but also upon the application of a discount receives less than proportional value for that loss of control."

The same rational applies to the rejection of the valuation discount for lack of marketability.

The court ordered Steven to buy out Richard's interest, minus a 6 percent liquidation discount. Steven appealed the court's determination of oppression as well as its rejection of the discounts for lack of control and lack of marketability. Richard appealed the application of the liquidation discount.

The court of appeals emphasized the stock purchase agreement and stressed the nature of the closely held family corporation. The fact that Steven was trying to squeeze out Richard constituted a breach of fiduciary duty, and it went against the agreement's purpose urging family members to continue their active association with the corporation.

The appellate court confirmed the trial court's valuation, and it rejected the application of discounts.

In the Matter of Zulkofske

In the Matter of Zulkofske, Peter and Virginia Zulkofske were a brother and sister who each owned 50 percent of the Brookhaven Agency, a retail/property casualty insurance company located in suburban New York. Family conflict prompted Virginia to petition the court for dissolution and accounting of the business.

Peter's son Nicholas was responding for his father, and claimed that Virginia did not own any shares of the company. However, Virginia was able to produce stock certificates proving her 50 percent ownership.

It was agreed that grounds for dissolution existed, and the court was requested to proceed with the winding down of the company's affairs.

At the last minute, Virginia asked that, rather than an order of dissolution, the Court consider a statutory appraisal and buyout of her shares at fair value. Virginia had a valuation analyst who specialized in valuing insurance agencies and who could testify in court.

The court offered to delay the proceedings so Peter's son could retain a valuation analyst, but Peter declined.

Peter's son Nicholas claimed that he produced and owned approximately 60 percent of the business. He confirmed that he was paid commissions on all his sales.

The valuation analyst hired by Virginia valued the insurance agency as of December 31, 2011, using an income approach and earnings-based valuation method. The valuation analyst concluded a value of just over $764,000, or $382,000, for her 50 percent share.

The court did not find it credible that Nicholas owned any of the corporate business. The court determined this was a successful continuing enterprise. And, the court concluded that the valuation analyst retained by Virginia was a credible valuation analyst with years of experience in the insurance industry.

The court directed Peter to purchase Virginia's shares for 50 percent of the corporate value, or $382,000.

What Went Wrong in These Cases?

From reading these judicial decisions, we can see that what went wrong in each matter is similar. In both cases, there should have been a clearly defined, written, and agreed-upon estate plan of the patriarch that originated each business.

It also appears that there was little transparency between family members and shareholder members. This could have been resolved if there were clearer rules for shareholder involvement or lack thereof.

Conclusion

Intergenerational wealth planning is a complicated and ever-evolving process. Naturally, as wealth increases, the opportunities and likelihood of shareholder litigation (specifically intrafamily litigation) increases exponentially.

There are many considerations when transferring the family business to the next generation. Successful transfers take several years to develop and successfully execute. Families need to start early in this planning process. Carefully developed strategies are important.

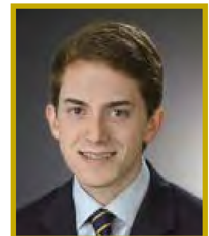
The results of an effective transfer can be very rewarding financially and emotionally for both generations. Assistance from professionals who work in this area and understand family issues and business issues are recommended to help family members have the best possible chance of reaching their goals.

Effectuating intrafamily transactions is an important component of the intergenerational wealth planning process. Advisers should constantly be considering the best practices to propose and implement each family's unique situation.

Having long-term advisers and implementing best practices will assist in the avoidance of unnecessary intrafamily shareholder litigation.

Notes:

1. Edler v. Edler, 745 N.W.2d 87 (Wis. Ct. App. 2007).
2. Zulkofske v. Zulkofske, 957 N.Y.S.2d 267 (N.Y. Sup. Ct., Suffolk County, June 28, 2012).
3. HMO-W Inc. v. SSM Health Care System, 611 N.W.2d 250, 256-257 (Wis. 2000).



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Valuation Issues to Consider for Large Block Minority Shareholder Redemptions

Jeffrey S. Burns and Nathan P. Novak

The purpose of this discussion is to identify certain issues to consider when performing a valuation analysis for the purpose of a closely held company shareholder redemption. Specifically, the focus of this discussion is on certain qualitative and quantitative factors that commonly arise when a closely held company is going through the process of redeeming or buying out an ownership interest of a significantly large but noncontrolling shareholder. Several considerations that are unique to large block noncontrolling shareholder redemptions are discussed below. Additionally, an example is provided to illustrate how certain of the issues can occur and can be handled in a hypothetical, but realistic, situation.

Introduction

A shareholder redemption, as that term is used throughout this discussion, occurs when a shareholder (or otherwise owner) of a company sells his or her shares back to the company. The shares may be retired or may be distributed among the remaining shareholders.

Ultimately, the result is the same either way:

1. There will be one less shareholder.
2. The remaining shareholders will own proportionately more of the company.
3. The overall value of the remaining shareholders' interests should be unaffected by the redemption.[1]

That is, in an equitable shareholder redemption, neither the redeemed shareholder nor the remaining shareholders should gain or lose wealth from the transaction.

There are several situations that can give rise to a shareholder redemption. A shareholder redemption can be mutual, such as if a shareholder wishes to sell his or her shares and the company agrees to buy them so as to avoid the presence of a new shareholder. Or, a shareholder redemption can be forced, such as if a shareholder claims he or she is being oppressed by the company and a court orders that company to redeem the oppressed shareholder's shares.

This discussion focuses on the valuation issues that arise during a litigious shareholder redemption, such as the issues related to the dissociation of an owner. Further, there are certain issues that are unique to the redemption of a noncontrolling shareholder that holds a significantly large block of the company stock.

Issues to Consider

There are certain general issues that commonly occur when a large block noncontrolling shareholder has his or her shares redeemed.

First and foremost, relevant statutes or judicial decisions should be considered, especially if the redemption is the product of litigation proceedings. Additionally, there are often key person risks that should be considered.

There are also a number of issues related to how the company will fund the shareholder redemption and the effect that it will have on the company going forward.

"... there are diverse legal issues that need to be considered depending on the context of the shareholder redemption or buy-out."

Legal Issues

The laws that govern relations between business owners vary depending on the jurisdiction and type of business that is owned. State laws on owner's rights differ from state to state and, similarly, the federal laws differ from the state laws.

Additionally, the laws that govern partnerships are often separate from the laws that govern limited liability companies or corporations.

Since a stock redemption can be effectuated through litigation, the relevant statutes can have a significant impact on the appropriate considerations when valuing a company for purposes of a stock redemption. Again, these statutes vary from state to state.

An article authored by Sandra K. Miller from the Spring 2011 issue of the *University of Pennsylvania Journal of Business Law* helps illustrate this point specifically in the context of limited liability company (LLC) member dispute when one member wishes to "get out" of the business.

> The Revised Uniform Limited Liability Act authorizes judicial dissolution for illegal, fraudulent, or oppressive conduct, but fails to offer provisions for a buy-out in lieu of a dissolution or any related valuation guidelines. In contrast, approximately twenty-two corporate statutes provide for a purchase in lieu of a judicial dissolution pursuant to the Model Business Corporation Act.[2]

And further in contrast:

> [T]he Delaware LLC statute authorizes judicial dissolution on the ground that it is not reasonably practicable to carry on business . . . [and] the Illinois LLC statute contains a buy-out provision in lieu of dissolution and specifies that the valuation is to be based on "fair value."[3]

Finally:

> California and Utah authorize a buy-out in lieu of dissolution and specify that the valuation should be with reference to "fair market value."[4]

Further, there are statutes that specify general valuation guidelines upon the dissociation of a partner from a partnership. Section 701 of the Revised Uniform Partnership Act states,

> [T]he buyout price of a dissociated partner's interest is the amount that would have been distributable to the dissociating partner . . . if, on the date of dissociation, the assets of the partnership were sold at a price equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern without the dissociated partner.[5]

Clearly, there are diverse legal issues that need to be considered depending on the context of the shareholder redemption or buy-out. Certain states, such as Illinois, specify the use of fair value when valuing shares for the purpose of a forced LLC shareholder buy-out. Other states, such as California and Utah, specify the use of fair market value for purposes of a buy-out whereas other states are silent on the appropriate standard of value.

Similarly, certain states prefer the use of a judicial dissolution of a business rather than a buy-out or redemption of a disassociated owner.

Ultimately, the take-away is that because statutes governing the redemption process differ significantly depending on the facts of a case, it is important to seek legal advice as a first step in order to determine which statutes or judicial precedent should be considered in a valuation for purposes of a stock redemption.

And, although the statutes and judicial precedents differ between jurisdictions, the overarching theme is that, upon an event that would necessitate a shareholder redemption in some form, the courts appear to want what is most equitable for both the departing owner as well as the remaining owner(s).

Key Person Risk

It is often the case that large shareholders of a privately held company are heavily involved with the operations of the company. This is especially true for smaller companies or for companies that are in the early stages of operations.

Those types of companies may be subject to significant key person dependency. Key person dependence exists when the performance of the company is highly dependent on one or a few key individuals, and the loss of any such individuals would materially impact the future success of the company.

The presence of a "key person" or key person risk is relevant when valuing a company for the purpose of a shareholder redemption. If the shareholder to be redeemed could be classified as a key person within the company, then the future financial performance of the company could potentially look very different after that individual shareholder has left the company.

As discussed above, the Revised Uniform Partnership Act specifically states that a buyout price may be based on a sale of the entire business *without the dissociated partner*.

Accordingly, since a shareholder redemption inherently involves the departure of the redeemed shareholder, the purchase price of the shares should be analyzed based on projected company performance in the absence of said shareholder.

Sandra Miller provides further guidance in her article, which states:

> [T]here may be unusual cases where a withdrawing LLC member may take goodwill and/or other intellectual property with him. In such instances, the buy-out price paid to the withdrawing LLC member might be grossly unfair and overstated without considering the value of the intellectual and/or intangible value withdrawn by the dissociating LLC member himself. The Comments to the Revised Uniform Partnership Act appear to recognize the possibility of discounts other than a minority interest discount and mention the key person discount.[6]

One way to capture the effects that a key person has on company value is to create a set of financial projections that directly removes any and all contributions by the key person. For example, consider a shareholder of a closely held company who is being redeemed and who is responsible for maintaining half of the company's customer relationships.

The customers for which the departing key person is responsible can be identified and certain assumptions could be made about which of these customers will stop doing business with the company due to the departure of that individual. A set of projections could be created that remove sales (and related costs) generated from the departing customers.

Other considerations can be made to include the removal of future compensation for the departing shareholder or the expense related to hiring a replacement. Ultimately, a set of projections that capture the effects of the loss of the key person can be used to accurately estimate the value of the company after the loss of the redeemed shareholder.

". . . key person risk is relevant when valuing a company for the purpose of a full shareholder redemption."

Another way to estimate the value of a key person is to investigate whether or not the company holds any insurance policies for the individual (or other individuals with similar functions within the company).

If a company holds an insurance policy on the redeeming shareholder, the face value of that policy may provide an estimate of the value that the company places on the contributions of that individual.

The face value of the insurance policy can be subtracted from the enterprise value of the company in order to reflect the loss in value due to the departure of the individual.

Finally, there may not be a direct way to quantify the effects that a loss of a key individual will have on a company. It may not be possible to create a set of financial projections that exclude the individual and the company may not hold any insurance policies on the key person.

When all else fails, it may be appropriate to capture the effect of the key person dependency through a more judgment-based valuation analyst adjustment.

The key person risk can be captured in an income approach through an adjustment to the present value discount rate. Similarly, the key person risk can be captured in a market approach by making an adjustment to the selected pricing multiples to account for the loss of the key individual. We note that these more indirect methods are generally more judgment-based and may be subject to scrutiny. Such methods should be supported, to the extent possible, with direct evidence.

Ultimately, although the issue of key person dependency is not unique to a shareholder redemption analysis, it is certainly common when a company fully redeems the shares of a large shareholder. It may be considered as the facts dictate or else the concluded value for the redeemed shares may be significantly overstated.

Funding Issues

Inherent in any shareholder buyout or redemption is the need to gather enough funds to pay the departing shareholder for his shares. Not surprisingly, this issue becomes increasingly important as the block size of the departing owner's interest increases in size.

As stated in the second court of appeal's opinion for *Jerry Rappaport v. Marvin Gelfand*, "Under the UPA, if there is a dissociation of a partner . . . the remaining partners have a right to continue the business and the dissociated partner has a right to be paid the buyout price of his or her partnership interest."[7]

Accordingly, since the remaining partners have a right to continue the business, it stands to reason that the buyout price of the departing partner should not be so great as to adversely affect the future operations of the business.

It is sometimes the case that a company will not have sufficient cash to purchase a block of stock that comprises a significant percentage of the outstanding shares. Accordingly, it may be necessary for the company to seek financing through the issuance of debt or equity.

Although the issue of financing for the purpose of a buyout is not often directly considered in a valuation analysis, it should not simply be ignored. As discussed above, since the purpose of a buyout is often not to dissolve the company, valuations for purposes of a buyout are often performed on a going-concern basis.

The buyout price and subsequent funding should not significantly burden the company to the point of failure. Therefore, the issues of the buyout price and access to financing in the context of the redemption are intertwined and should be considered against one another.

For purposes of a shareholder redemption, a company will typically seek financing through debt (i.e. a bank loan, issuance of bonds, etc.). Of course, the first consideration is whether or not the company will be able to secure enough financing to fund a significantly large buyout.

From a lender standpoint, one consideration is whether or not the company has sufficient cash flow to make interest and principal payments on its debt. For example, consider a company that has limited cash flow projected for the next several years due to significant planned capital expenditures. It may be the case that the company simply would not have cash flow available to both satisfy significant debt service payments and also make the planned capital expenditures.

Further, if a company already has debt outstanding, there may be restrictive covenants that prevent it from borrowing a large enough amount to fund a buyout. Ultimately, it may be the case that certain factors prevent the company from realistically borrowing enough funds at a given buyout price.

In the prior example, if a company has to select between making capital expenditures and securing debt, it begs the question of how does such a determination affect the value of the business?

Clearly, if a redemption causes the projected future cash flow of a company to materially change (as opposed to the projected cash flow in the absence of a redemption), then that may be a consideration in determining the buyout price of the shares.

The issue of financing a buyout or redemption may ultimately be used as a reality check against the concluded buyout price.

If the price is so high that the projected company cash flow simply does not allow it to reasonably secure enough financing at the given value, it may be the case that certain assumptions or risk factors should be revisited.

Ultimately, the act of securing financing should not be so burdensome that it materially adversely affects the future performance of the company. If this is the case, the intention of valuing the business under the assumption that the remaining shareholders have a "right to continue the business" may be violated.

An Illustrative Example

In order to better explain some of the points described above, we present an example of some factors that an analyst may consider when developing his or her value conclusion.

This is not intended to be a comprehensive example, but is rather an example of certain things which would likely be discussed throughout a valuation report, such as valuation variables, conclusions, and background information.

Let's assume that Tom, a valuation analyst with Business Valuation, Inc., was retained by legal counsel to provide his opinion of value of a 50 percent membership interest in ProCamps, LLC ("ProCamps").

The case relates to a dispute in which Tony, a 50 percent member of ProCamps, a California privately held limited liability corporation, is attempting to buy out the remaining 50 percent member, Jim, and there is disagreement on the value of the company.

The following discussion describes some of the significant issues that Tom discussed in his valuation report.

Company Background

1. ProCamps began offering youth hockey camps five years ago. It has short-term contracts with 20 of the 30 professional hockey teams in the National Hockey League (NHL).

The camps are held in locations nearest the contracted NHL teams.

On the final day of camp, the contracted team will send one of their current NHL players to make an appearance at the camp, sign autographs, and provide additional instruction.

2. Tony and Jim, the two members of ProCamps, are former professional hockey players. Tony spent his entire career playing for NHL teams in the western conference and, in turn, has personal relationships with several western conference NHL teams.

   Similarly, Jim spent his entire career playing for NHL teams in the eastern conference and maintains relationships with several eastern conference teams.

   Additionally, Tony's brother, a successful real estate investor, owns 6 of the 20 hockey rinks where ProCamps conducts its camps.

3. The ProCamps revenue has grown rapidly, and in the latest 12 months, ProCamps has revenue of $40 million and has operating income of $1 million. This is the first year ProCamps earned a profit. ProCamps expects minimal revenue growth, but expects profit margins to increase each year.

4. ProCamps owns very few tangible assets but has significant intangible value.

5. ProCamps currently has revolving debt with a limit of $5 million.

Valuation Analysis and Valuation Variables

1. Tom used an income approach and, specifically, the discounted cash flow valuation method.

2. In his income approach analysis, Tom created a five-year discounted cash flow model based on financial projections that were provided to him by ProCamps management.

3. Tom estimated the ProCamps weighted average cost of capital to be 15 percent. This was based on a weighting of ProCamps capital structure of approximately 5 percent debt and 95 percent equity.

   The ProCamps estimated cost of equity was 16 percent, which included a company-specific equity risk premium (CSRP) of 1 percent.

   Tom explained the CSRP to account for the key person risk inherent in ProCamps business.

4. Tom concluded a marketable, controlling interest value for a 50 percent membership interest in ProCamps to be $25 million.

Additional Consideration

Tom may have overlooked many issues that are relevant to this analysis including the following:

1. Legal issues
2. Key person risk
3. Funding issues

Legal Issues

The concluded value of $25 million assumes that the equity capital of ProCamps is as liquid—or as readily marketable—as publicly traded securities. Tom incorrectly did not apply a discount for lack of marketability.

Tom failed to realize that California statute specifies the valuation should be on a fair market value basis, as discussed previously. In this case, appropriate valuation discounts may have been applied. Failing to apply valuation discounts may result in an overvaluation of Jim's 50 percent membership interest in ProCamps.

Key Person Risk

Although Tom applied a 1 percent CSRP and suggested that it accounted for key person risk, he most likely underestimated this risk. It is clear that ProCamps has certain company-specific risk factors, including the following:

1. Key person dependence
2. The risk of losing contracts with NHL teams

ProCamps appeals to youth camp participants because of its affiliations with NHL teams and their players. ProCamps has been successful in growing its business due to Tony's and Jim's personal relationships they each developed during their careers in the NHL. Because of these relationships, they were able to secure short-term contracts with several NHL teams.

Without Tony's and Jim's personal relationships, ProCamps might not be affiliated with these NHL teams, and in turn, ProCamps might experience a large decrease in camp enrollment. This example illustrates the key person risk that may be inherent in the ProCamps business.

Additionally, ProCamps has negotiated favorable contracts with several of the ice rinks where ProCamps conducts its camps. Tony's brother allows ProCamps to hold camps at his ice rinks at a significant discount to the usual user fee. Tony has indicated that, because of the reduction in costs, ProCamps is able to operate at higher margins than normal.

Losing out on these favorable contracts might negatively affect ProCamps business. The possibility of losing out on these favorable contracts is an additional risk to ProCamps business.

Based on these identified risks specific to the ProCamps business, it may be appropriate to add an additional CSRP to ProCamps cost of equity capital to account for these risks. It is up to the valuation analyst to properly estimate the effect these risks have on the specific business and apply an appropriate CSRP that accounts for these risks.

Alternatively, Tom could have adjusted the company financial projections to account for the absence of Jim. Of these two methods, one is not necessarily superior to the other. The analyst may decide which method would result in a more accurate estimation of value subsequent to the departure of the key person.

Funding Issues

Tom failed to consider the implication that his $25 million buyout price would have on ProCamps business. The price that is to be paid to a redeeming member for his membership interest should not force the liquidation of the business. Forcing ProCamps to pay $25 million may affect its ability to operate as a going concern.

ProCamps has very little cash available, and therefore, it would have to borrow a significant portion of the $25 million buyout price. As mentioned above, ProCamps had a credit limit of $5 million on its revolving debt.

It may be fair to assume that no bank would be willing to provide ProCamps a $25 million long-term loan. Even if ProCamps was somehow able to obtain debt financing of $25 million, principal and interest payments on this loan would have an impact on the future cash flow of ProCamps.

The point to make here is that when reaching the value conclusion, the valuation analyst should consider (1) whether the company has the ability to obtain financing in the amount of the buyout price and (2) whether servicing the debt would affect the company's ability to operate as a going concern.

Summary and Conclusion

As discussed above, several issues may have a significant impact on the concluded value that is used in a shareholder redemption transaction. The issues outlined above are just a few of the issues to consider when valuing a large block of shares for purposes of a redemption.

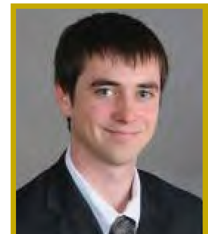
The issues described above are by no means exhaustive, but there are a few issues that may go unnoticed by a valuation analyst.

In general, when developing a value conclusion for a large share block redemption, a valuation analyst may consider the following:

- Any legal issues applicable to the subject entity's specific jurisdiction
- If there is any key person risk inherent with company management, particularly with the departing shareholder
- If it is feasible for the company to fund a share redemption based on the concluded value

Notes:

1. We note that the shareholder redemption process we refer to throughout this article contemplates a full redemption (i.e., the selling shareholder no longer holds any stake in the company).
2. Sandra K. Miller, "Discounts and Buyouts in Minority Investor LLC Valuation Disputes Involving Oppression or Divorce," *University of Pennsylvania Journal of Business Law* (Spring 2011): 5.
3. Ibid.: 5–6.
4. Ibid.: 6.
5. Rev. Uniform Partnership Act Section 701 (2014-2015 ed.), §701(b).
6. Miller, "Discounts and Buyouts": 16.
7. Rappaport v. Gelfand, 197 Cal.App.4th 1213 (2011), 5.



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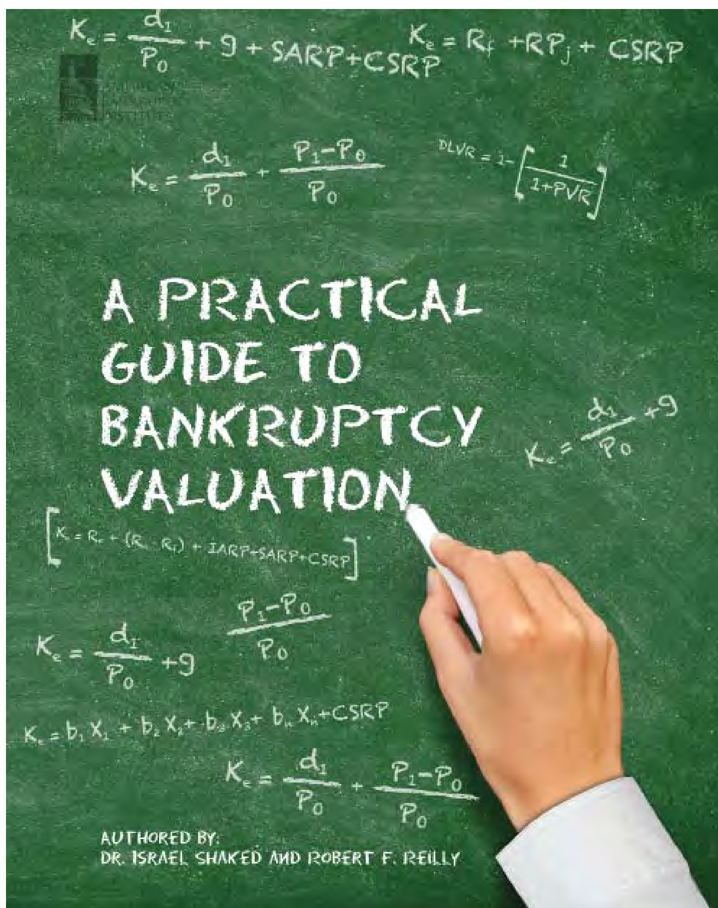

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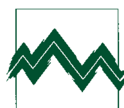

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A PRACTICAL GUIDE TO BANKRUPTCY VALUATION

Dr. Israel Shaked and Robert F. Reilly

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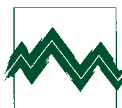

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Entity-Level versus Ownership-Level Valuation Adjustments

Terry G. Whitehead and Charles A. Wilhoite, CPA

Shareholder oppression and dissenting shareholder appraisal rights cases ("dissenter cases") generally are characterized by a circumstance in which an owner maintaining a less-than-controlling ownership interest leaves the ownership group under less than ideal circumstances, typically requiring the valuation of the separating owner's equity interest in the subject business. Legal statutes and judicial precedent typically dictate the valuation process that reasonably can be relied upon to estimate the value of the separating owner's equity interest. Two of the most contentious issues addressed in a dissenter case from a valuation perspective relate to whether it is appropriate to apply a discount for lack of control (DLOC) and a discount for lack of marketability (DLOM) when estimating the value of the dissenter's equity interest. While the courts generally have moved in the direction of disallowing the DLOC and DLOM, valuation analysts still consider and address certain "entity-level" adjustments that affect equity value to all owners, equally.

Introduction

Dissenter cases occur with high frequency and typically trigger the valuation process for a privately held company. Various circumstances may create the valuation requirement regarding such disputes. Additionally, these actions fall under the jurisdiction of each individual state.

As a result, there is no single, universal standard of value or valuation process. Rather, it is necessary to review the appropriate statutes and prior case law in the relevant jurisdiction in order to determine the appropriate standards and requirements for a particular matter.

Generally, however, the standard of value in dissenter cases is fair value. This standard of value typically is different than the more commonly recognized fair market value standard, which is the standard relevant for federal gift tax and estate tax purposes.

The most notable differences between these two standards of value are the interpretation and implementation of valuation discounts, such as a discount for lack of control (DLOC) and a discount for lack of marketability (DLOM).

For purposes of this discussion, we will consider the fair value definition as stated in the 1999 Revised Model Business Corporation Act:

> The value of the corporation's shares determined immediately before the effectuation of the corporate action to which the shareholder objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal without discounting for lack of marketability or minority status except, if appropriate, for amendments to the articles pursuant to section 13.02(a)(5).

A common interpretation of this definition has been to define fair value as the "pro rata value of the entire company as a going-concern entity." This is the general definition we will assume for purposes of this discussion.

It is correct to assume, based on the previous definition, that the valuation process should not include a reduction in value attributable to a DLOC or a DLOM. However, it would be incorrect to assume that the fair value standard and related valuation process in a dissenter case requires the exclusion of all potential valuation adjustments that potentially affect the overall enterprise value.

In other words, it is important that the valuation analyst distinguish between valuation considerations that affect the overall company value and valuation adjustments that affect value at the specific owner level when estimating fair value in a dissenter case.

In addition to a DLOC and a DLOM, there are other potential valuation considerations and adjustments that may be relevant when valuing a business, whether the ultimate objective is estimating the fair market value, fair value, or investment value of a subject interest.

In order to appropriately identify and properly quantify adjustments to a company's value and underlying stock, it is necessary to identify and properly categorize such adjustments. Broadly speaking, valuation adjustments can be placed in two categories:

1. Entity-level adjustments
2. Ownership-level adjustments

Entity-level adjustments are those considerations and related valuation adjustments that affect the value of the subject entity regardless of the rights and restrictions inherent in the specific ownership interest under analysis.

Ownership-level adjustments, on the other hand, represent those considerations and related valuation adjustments that are directly attributable to the rights, privileges, management, and control attributes, or lack thereof, inherent in the specific ownership interest under analysis.

Ownership-level discounts include adjustments commonly labeled as a DLOC or a DLOM. Under the assumed fair value standard used in this discussion, the conclusion of value for a noncontrolling owner's interest in a dissenter case should exclude consideration of ownership-level discounts.

However, to the extent certain entity-level considerations are relevant, a potential valuation adjustment may be appropriate even under a fair value standard in a dissenter case.

DLOC and DLOM

If one strictly interprets the definition of fair value as a "no discounts" standard of value, the related analysis may result in a conclusion that does not properly reflect the impact of valuation considerations and related adjustments that are appropriate and necessary under the applicable fair value standard in a dissenter case.

This conclusion is based on the fact that, typically, there are a number of risks and value considerations affecting an entity that are not specifically attributable to the degree of shareholder control or the absence of an established trading market for the subject company's stock.

Theoretically, the DLOC and the DLOM typically are viewed as inapplicable in a dissenter case after all relevant entity-level considerations and related adjustments have been applied. The rationale for excluding a DLOC and a DLOM in a fair value context is that the dissenting shareholder should not be penalized (or the appraised value negatively affected) for factors outside of the shareholder's control.

Such factors include the following:

1. The dissenting shareholder's inability to exert control over the operations and other prerogatives available to a controlling shareholder
2. A stock that is not publicly traded or otherwise convertible into a near-certain amount of cash within short period of time (i.e., three to five days)

However, ensuring that the dissenting shareholder is not negatively affected by a DLOC or a DLOM does not result in the elimination of other company-specific factors that have the potential to exert an impact on value.

The following discussion summarizes certain entity-level discounts that may be relevant and require an adjustment to value, even under a fair value standard in a dissenter case.

Entity-Level Considerations

Although there are a number of entity-level factors not directly related to the DLOC or DLOM that have the potential to exert impact on value, for purposes of this discussion, we will limit the discussion to the following potential adjustment considerations:

1. Key person risk
2. Pass-through entity structure
3. Company-specific risk
4. Conglomerate structure

Key Person Risk

Whether the continuing economic viability of a company is dependent on a key person(s) is not an ownership-level consideration, but rather, an entity-level consideration. Whether a dissenting shareholder holds a 10 percent ownership interest, or a controlling shareholder holds a 90 percent ownership interest, if there is a key person, it is a risk that affects all owners equally. This is because such a risk affects the entire company and the value of the company.

Further, such risk exists whether a company is publicly traded or privately held. However, this risk is often mitigated in the public company setting by greater depth in management and staffing.

Clearly, key person risk is a valuation consideration that may be addressed, even in a dissenter case. This is because it is not directly related to a DLOC or a DLOM.

Assuming the key person risk will remain an attribute of the company before and after the "corporate action," it should necessarily be considered to represent an entity-level adjustment (i.e., potential discount) rather than an ownership-level adjustment.

In other words, the result of the corporate action typically would not result in the elimination of the key person risk. Therefore, it may be inappropriate to ignore the potential impact that key person risk may exert on value.

Failing to address the potential detrimental impact that key person risk may exert on value could result in the overvaluation of the subject company. This may provide the dissenting shareholder an excessive return relative to the value that would remain for the nondissenting shareholders.

Therefore, it is appropriate for an analyst to identify whether the facts and circumstances establish the existence of key person risk within the subject company.

If key person risk is determined to exist, an analyst often assess the impact such risk exerts on value, and appropriately reflect the effect of key person risk in the conclusion of value.

Key person risk may be addressed by (1) separately applying a specific discount to value or (2) incorporating an incremental risk premium component in the development of the discount/capitalization rates used to complete the income approach.

Within the market approach, it may be appropriate to apply a discount to reduce the otherwise estimated market multiple(s) to address key person risk and other attributes that are deemed to be distinguishing characteristics between the subject company and the selected guideline companies.

Pass-Through Entity Structure

A pass-through entity is an entity that does not pay income tax at the corporate level, but instead pays income tax primarily at the shareholder or owner level (e.g., S corporation, partnership, limited liability company). Owners of a pass-through entity are required to pay income taxes on their allocated level of business earnings (regardless of the level of earnings actually received through distributions).

Regular C corporations, on the other hand, pay income taxes at the business level (on earnings), and distributed earnings are taxed again at the shareholder level (on dividends).

From a valuation perspective, it is generally recognized that there is an incremental benefit to the pass-through entity shareholder resulting from the fact that earnings are not subject to the double taxation experienced by shareholders of a regular C corporation. This benefit is commonly characterized as a pass-through entity premium.

However, there are a number of additional considerations to be addressed within the context of fair value in a dissenter case relating to the analysis of pass-through entities.

First, depending on the valuation method utilized, the application of a pass-through entity premium may not be appropriate. Because the valuation process in a dissenter case often involves the estimation of value excluding the impact of a DLOC and a DLOM, the valuation methods selected generally are designed initially to produce a controlling-basis level of value.

Within the valuation community, debate continues regarding whether a pass-through entity premium is appropriate for a controlling-basis level of value and, if so, to what extent.

Second, if a pass-through entity premium is applied, it is also necessary to consider other potential circumstances regarding a pass-through entity beyond the well-documented elimination of double taxation.

Generally, owners in a pass-through entity structure are well aware of the fact that if the company does not generate and maintain sufficient distributable cash, they are still required to pay income taxes on their proportionate share of earnings. This is a significant risk consideration for an owner in a pass-through entity that can often be overshadowed by the "expected" benefit of a single level of taxation.

In many valuation settings, this risk is often considered in the estimation of an appropriate level of

DLOM for the specific shareholder interest. Factors considered include the subject company's level of historical and expected distributions relative to actual and expected allocated shareholder earnings.

A history/expectation of shareholder distributions that do not equal or exceed shareholder tax liabilities based on allocated earnings creates a strong argument for no pass-through entity premium, or even for a discount.

The fair value standard in a dissenter case often results in the disallowance of a DLOM. As a result, it is important that a valuation analysis does not calculate a benefit for the entity structure (pass-through entity premium) without recognizing the associated risks (taxable earnings without available distributions).

Although pass-through entity status is an entity-level consideration, it is a circumstance that also has ownership-level attributes which may not be separable under fair value in a dissenter case.

Company-Specific Risk

Within the standard valuation approaches, market evidence and transaction data often are considered by an analyst for the purpose of estimating valuation factors such as rates of return and market pricing multiples. In order to appropriately estimate the subject company's value, it may be necessary to complete an appropriate comparative analysis regarding the subject company and the data utilized.

To the extent the subject company has identifiable differences in attributes relative to the market-based data considered, an adjustment to the baseline, or comparative, data may be considered to address the increase or decrease in relative subject company risk. Examples of company-specific risk differences may include customer concentration, product/market concentration, quality/depth of management team, capital limitations, and growth prospects.

As the name implies, company-specific factors typically are categorized as entity-level considerations. However, it is often the case that these company-specific factors are minimized, or even ignored, if inappropriately categorized as attributes falling under the control-level umbrella.

A clear distinction needs to be made to separate company-specific factors, which would remain in place regardless of the control owner, and those factors that may be operating prerogatives of the controlling owner.

Conglomerate Structure

A conglomerate is an entity that is made up of a number of different, and typically, unrelated, businesses. Generally, a conglomerate company owns a controlling interest in a number of smaller companies that conduct operations independently from the parent conglomerate company.

Within the public stock markets, the value of a conglomerate is often less than the value that would be derived from the sum of its parts.

The question of fair value in a dissenter case then becomes: Is the subject company a conglomerate, and if so, is the fair value of the subject company simply the sum of its parts or is there a required discount attributable to the ownership structure and operation as a conglomerate that is not directly related to a DLOC or a DLOM?

The conglomerate structure potential impact on value may be appropriately categorized as an entity-level consideration. Therefore, it seems logical that a discount for conglomerate status may be appropriate under the fair value standard, as such a discount does not relate directly to ownership status or the marketability of the subject ownership interest.

Rather, the conglomerate structure impact is a value consideration that relates to the ownership of multiple entities across multiple business lines (diversification).

Such diversification may have multiple implications, including the following:

1. A potential reduction in overall company risk
2. A potential reduction in overall company value attributable to potential inefficiencies attributable to the nonhomogeneous operations

As a result, consideration may be given in a fair value context in a dissenter case to the assemblage of nonhomogeneous assets. Unless the conglomerate status of a company is the subject of dissent, the structure and value of the subject company is based on conglomerate status, which may be the case before and after the dissenter action.

This type of discount is commonly seen in the marketplace. For example, the value of companies A, B, and C may be X, Y, and Z on an individual basis. However, if you purchase company D (which is the sum of companies A, B, and C), the value is likely W (X+Y+Z, minus some level of discount for the grouping of dissimilar operations).

In order for the conglomerate to be sold in a single transaction, it is likely that it will suffer the impact of a conglomerate, or portfolio, discount.

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Defining "Value" in Ownership Agreements

Scott R. Miller and Charles A. Wilhoite, CPA

Articles of incorporation, articles of organization, and partnership agreements often contain provisions designed to facilitate the transfer of ownership interests under specified circumstances. Such provisions typically define the terms under which the ownership interest of a departing shareholder, member, or partner is redeemed, or purchased, including describing how value—that is, the purchase price—will be determined. Unfortunately, the definition of value provided in many corporate documents lacks the specificity required to address the circumstances that have the potential to exert significant impact on value, often resulting in extended, acrimonious, and expensive litigation. Therefore, a clear definition of value in ownership agreements is important.

Introduction

Ownership agreements are an important tool used to define a closely held business owners' rights and obligations, and ultimately to protect the interests of the owners. Ownership agreements may take many forms, including the following:

1. Bylaws
2. Buy-sell agreements
3. Shareholder agreements
4. Operating agreements
5. Partnership agreements.

In this discussion, we will use the term "ownership agreement" to refer to any type of ownership agreement that regulates the transfer or sale of ownership interests.

When drafting an ownership agreement, owners may incorporate one of any number of mechanisms for the purpose of determining price. These mechanisms include the following:

1. A fixed price
2. A price based on a formula
3. A price based on a specific valuation process
4. A valuation to be conducted by a qualified valuation analyst

However, owners often overlook the specifics concerning the definition of "value" to be applied in each of these scenarios.

Many ownership agreements do not provide a specific definition of "value," leaving the concept open to disagreement due to the resulting ambiguity. Instead, some ownership agreements use vague terms such as "market value" or "appraised value" to represent the price at which a selling owner will be redeemed.

When "value" is not clearly defined in an ownership agreement, the result is often a dispute between the terminating, or selling, owner and the continuing owner(s). In some cases this may lead to an extended litigation process. This is one reason why it is helpful to clearly define "value" as it pertains to the price at which an owner's interest will be redeemed at the time of a triggering event.

The definition attributed to "value" has the potential to positively affect either the selling owner or the remaining owner(s), when in fact value is generally intended to result in a "fair" economic transfer to all parties.

For example, a selling owner who owns less than a controlling interest may benefit if "value" is defined as the selling owner's pro rata share in the enterprise value of the business, without any discounts for lack of control or for lack of marketability.

Alternatively, the remaining owner(s) may benefit if the definition of "value" requires the inclusion of a lack of control and lack of marketability discount when such considerations were never initially contemplated.

At the time an ownership agreement is drafted, owners, to their detriment, may (1) not consider the impact that different definitions of "value" can exert on price or (2) hope that the definition of "value" relied on will benefit them.

However, an owner's exit scenario—often contemplated to occur decades beyond the entity formation date—rarely is considered fully at the onset of a venture. Therefore, it is in the best interest of all owners to clearly define their intent in an ownership agreement, rather than assuming, or hoping for, the best.

This discussion will:

1. provide common "value" definitions, including the standard, premise, and level of value;
2. identify and address additional, relevant considerations when defining "value," including intent and historical precedent; and
3. provide excerpts from ownership that define "value" in different ways.

Defining "Value"

Value can be, and is, defined in a number of ways in ownership agreements. Three important concepts that must be addressed in order to appropriately and clearly define value are:

1. the standard of value,
2. the premise of value, and
3. the level of value.

Standard of Value

The standard of value is the type of value being sought. The standard of value is specific to the ownership interest, the buyer and seller, and the context in which the ownership interest is being valued. The standard of value influences, and sometimes compels, the approaches and methods used by a valuation analyst to value an entity.

Common standards of value include the following:

- Fair market value
- Investment value
- Intrinsic value
- Fair value (in the context of state legal matters)

Fair market value is defined as "the amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts."[1]

Fair market value generally is understood to represent consideration on a "cash-equivalent" basis.

Investment value is defined as "the specific value of goods or services to a particular investor (or class of investors) based on individual investment requirements. . . ."[2]

Investment value may differ from fair market value (from the perspective of a particular owner) for the following reasons:

1. Differences in estimates of future earning power
2. Differences in perception of the degree of risk and the required rate of return
3. Differences in financing costs and tax status
4. Synergies with other operations owned or controlled

Intrinsic or "fundamental" value is defined as "an analytical judgment of value based on the perceived characteristics inherent in the investment, not tempered by characteristics peculiar to any one investor, but rather, tempered by how these perceived characteristics are interpreted by one analyst versus another."[3]

Intrinsic value is considered to represent the "true" or "real" worth of an item based on an objective evaluation of available facts.

Fair value (in states that have adopted the Uniform Business Corporation Act) is often defined 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 would be inequitable."[4]

Fair value in terms of business valuation (and not necessarily financial reporting) is usually a legally created standard of value that applies to certain specific transactions.

In most states, fair value is the statutory standard of value applicable in cases of dissenting stockholder appraisal rights.

Premise of Value

The premise of value reflects the actual set of hypothetical transactional circumstances applicable to an ownership interest. Much like the standard of value, the premise of value is specific to the ownership interest, the buyer and seller, and the context in which the ownership interest is being valued.

The premise of value may also influence the approaches and methods relied on by a valuation analyst to value an entity.

The premise of value can be classified in the following ways:

- Value as a going concern
- Value as an assemblage of assets
- Value as an orderly disposition
- Value as a forced liquidation

Value as a going concern is defined as "value in continued use, as a mass assemblage of income-producing assets, and as a going-concern business enterprise."[5]

The going-concern premise of value typically is used in business valuations where the subject company is expected to continue operating into the foreseeable future. The going-concern premise of value may be especially relevant to (1) entities with significant intangible value and (2) noncontrolling ownership interests with no ability to cause the sale or liquidation of assets.

Value as an assemblage of assets is defined as "value in place, as part of a mass assemblage of assets, but not in current use in the production of income, and not as a going-concern business enterprise."[6]

Value as an orderly disposition is defined as "value in exchange, on a piecemeal basis (not part of a mass-assemblage of assets), as part of an orderly disposition; this premise contemplates that all of the assets of the business enterprise will be sold individually, and that they will enjoy normal exposure to their appropriate secondary market."[7]

Value as a forced liquidation is defined as "value in exchange, on a piecemeal basis (not part of a mass assemblage of assets), as part of a forced liquidation; this premise contemplates that the assets of the business enterprise will be sold individually and that they will experience less than normal exposure to their appropriate secondary market."[8]

Level of Value

The level of value reflects characteristics of ownership, such as controlling versus noncontrolling ownership status, and the liquidity, or lack thereof, inherent in the ownership interest. Applicable valuation adjustments—for example, discounts or premiums—related to the level of value are ownership level adjustments that may apply to a specific ownership interest.

"Value" sections in ownership agreements should be clear regarding references to the permissibility or impermissibility of discounts or premiums related to the level of value for a specific ownership interest.

The level of value can be classified in the following ways:

- Synergistic level of value (i.e., value assuming a strategic buyer)
- Controlling level of value (i.e., value assuming a controlling buyer)
- Noncontrolling, marketable level of value (i.e., value assuming a noncontrolling ownership interest that is readily marketable or easily converted to cash)
- Noncontrolling, nonmarketable level of value (i.e., value assuming a noncontrolling ownership interest in a nonpublic company)

The level of value for an ownership interest subject to analysis may affect the methods an analyst relies on to value the subject company, as well as how the methods are applied. For example, an analyst typically would not consider a net asset value (e.g., liquidation-based) approach when the level of value for a particular ownership interest is defined as noncontrolling.

Similarly, an analyst may make adjustments to historical and projected earnings if the defined level of value for a particular ownership interest is controlling, and a hypothetical, controlling buyer would have the ability to cause such changes.

The level of value may influence the discounts and premiums applied to the subject ownership interest. Such discounts and premiums may be significant and may account for over 50 percent of the equity value in some scenarios.

Identifying the appropriate level of value can be confusing and challenging for owners, especially when there are varying rights among ownership interests and varying sizes of ownership interests. If the applicable level of value is not defined or described clearly in an ownership agreement, conflicts likely may arise between interested parties at the time of a triggering event or buy-out.

Intent and Historical Transactions

Relevant provisions of ownership agreements generally are understood to address the question regarding the "value" of ownership interests from the perspective of those forming/participating in the subject business. The initial formation of an entity typically contemplates the potential departure of owners prior to the expiration or dissolution of the entity.

Historical practice suggests that "value" typically is contemplated from an equity perspective (i.e., "fairness"). As the terms of an ownership agreement typically are negotiated and agreed upon by the parties covered by the agreement, it stands to reason that at least an attempt was made to incorporate terms that all parties believed were fair and reasonable at the time the agreement was developed.

Valuation analysts typically address the question of owner "intent" based primarily on consideration of observable, historical practice with regard to the implementation of a particular ownership agreement. Clearly, legal interpretation may be warranted.

Generally accepted valuation practice (for example, Revenue Ruling 59-60 issued by the Internal Revenue Service) suggests consideration of historical transactions in a company's equity when estimating fair market value.

Timely, historical transactions in a company's equity—in circumstances determined to be arm's-length—provide relevant information that reasonably can be considered when estimating the value of the equity of a company for redemption purposes.

A history of transactions in the equity of an entity often serves to neutralize "value" terms within an ownership agreement if "value" was defined or established in an inconsistent manner.

Historical transactions may be a key consideration when examining the intent of owners regarding the definition of "value" included in an ownership agreement. The analysis of historical transactions can provide insights with regard to owner intent relating to "value."

Further, historical transactions may also influence court decisions when there is a dispute over the applicable definition of "value."

For example, in *Estate of Maurice F. Frink v. Flowerama of America, Inc.*,[9] the estate argued that fair market value should be used as the relevant standard of value. The company argued that accounting book value was the applicable standard of value because it was defined in the subject ownership agreement as such.

In its decision, the court noted that **past redemptions** were made at book value and ultimately decided in favor of using book value as the price at which the estate was redeemed.

Past transactions, occurring at arm's length, allow disputing owners, or a court, to objectively analyze what definition of "value" may be most appropriate in a certain circumstance.

If prior arm's-length transactions have occurred under a certain standard, premise, and level of value, this adds validity to an owner's claim that such definition of "value" is unbiased and relevant to apply in an ownership redemption occurring under similar circumstances.

Examples of "Value" Definitions in Actual Ownership Agreements

This section presents examples of different definitions of "value" included in actual ownership agreements.

Example 1

> The option will be exercisable for an amount ("option price") equal to the product of (1) the **fair market value** of the company as a **going concern** taking into account the company's assets and the then-outstanding obligations of the company, including any unpaid balance of the preformation indebtedness, on the date of the triggering event; (2) the decimal equivalent of the percentage interest represented by the interest subject to option; and (3) the decimal equivalent of 60%. The 60% factor in the foregoing formula is intended to subject the product determined under clauses (1) and (2) to a 40% **discount to take into account a reasonable discount for lack of marketability and for noncontrolling ownership interest**. This 40% discount has been arrived at through arm's-length negotiation among the parties and, accordingly, is and will be deemed fair and reasonable under the circumstances.

This ownership agreement excerpt specifies "value" from three perspectives. The standard of value is clearly defined as "fair market value." The premise of value is clearly defined as "going concern."

Additionally, this agreement clearly states that the level of value will be noncontrolling and

nonmarketable. The agreement even goes so far as to define the exact level of discounts for lack of control and for lack of marketability considerations, in theory removing the decision from the hands of potential disputing parties and their valuation analysts.

The unique aspect of this ownership agreement is the predetermination of a level of discount to apply to the subject ownership interest. This tactic aims to remove some of the ambiguity, and, therefore, potential conflict between buyer and seller, regarding the appropriate level of combined discounts for lack of marketability and for lack of control.

Although the subject ownership agreement clearly states the definition of "value" based on the three key considerations previously discussed (i.e., the standard of value, premise of value, and level of value), room still exists for potential disagreement.

The company (i.e., the buyer) may argue that "fair market value" should be determined from the perspective of a noncontrolling owner prior to the application of the predetermined 40 percent discount.

This could include incorporating a noncontrolling level cash flow in the income approach and discounts to any market multiples derived from the analysis of controlling-interest transactions for the purpose of completing the market approach (i.e., the guideline transactions method).

The party exercising the option (i.e., the selling owner) may argue that "fair market value" should be determined from the perspective of a controlling owner. This could include incorporating a higher level of cash flow from the perspective of a controlling owner in the income approach and the application of premiums to market multiples derived from the analysis of noncontrolling, publicly traded interests for the purpose of completing the market approach (i.e., the guideline publicly traded company method). The justification being that a discount for lack of control is warranted only to the extent that a corollary control premium is incorporated in the initial fair market value conclusion.

The validity of each of these arguments may increase or decrease depending on the (1) size of the ownership interest subject to option or (2) rights and benefits inherent in the ownership interest subject to option.

If the size of the ownership interest subject to option approaches 50 percent, or if the subject ownership interest affords the owner significant attributes of control, an argument could be made for a control level of value (prior to the predetermined 40 percent discount).

If the selling owner is indeed a noncontrolling owner by all accounts (i.e., unable to exert any influence on the operations of the subject company), an argument could still be made that an excessive level of discount for lack of control has been incorporated in the option price based on (1) a claim that the pre-discounted fair market value inappropriately excludes any level of control premium, and (2) the basis for, and form of, the predetermined 40 percent combined discount (i.e., such a discount may be relevant and reasonable at a point in time, but nor over all time, particularly as it relates to the portions allocable to lack of control and lack of marketability).

The subject ownership agreement goes on to read as follows:

> In any case in which the company acting through the board of directors and the optionor (each a "party") are unable to agree upon the fair market value of the company as a going concern (taking into account the company's assets and then then-outstanding obligations of the company, including any unpaid balance of the preformation indebtedness) within the 30-day period for such agreement under Section 2.6(b), each shall give a notice to the other appointing an appraiser.

Although this agreement goes to great lengths to define "value," ultimately there may be a significant divide between different valuation analyst's interpretations of "fair market value" given the circumstance of a mandatory 40 percent discount.

Example 2

> The value of the affected shareholder's ownership interests will be determined by multiplying the shareholder's percentage ownership interest by the fair market value of the company (**the amount that could reasonably be expected to be realized upon sale**) net of liabilities of all company assets, with appropriate discount for a noncontrolling interest or lack of marketability. Provided, however, in the event the triggering event is the death of a shareholder as provided in Section 9.6 above, the value of the deceased shareholder's ownership interest will **not include any discount for a noncontrolling interest or lack of marketability**.
>
> The fair market value of the company assets will be determined by agreement between a majority in interest of the

> remaining shareholders holding all shares (voting and nonvoting) and the affected shareholder or the affected shareholder's successor. In the event an agreement as to the value cannot be obtained, the fair market value of the company's assets will be determined by a valuation. The company will first select a valuation analyst who will value the company's assets.
>
> The affected shareholder or the affected shareholder's successor may elect, either before or after the company has submitted a report, to select another valuation analyst.
>
> In the event the two appraisers fail to reach agreement on the fair market value of the company's assets, the two valuation analysts will mutually select a third appraiser whose determination of the value of the company's assets will be binding on the company and the affected shareholder or the affected shareholder's successor.

The subject ownership agreement excerpt defines the standard of value as the "fair market value of the company." The subject ownership agreement goes on to clarify the specific basis for establishing fair market value as "the amount that could reasonably be expected to be realized upon sale" (of the entire company).

The subject ownership agreement also specifies when discounts for lack of control and lack of marketability should be considered, and when such discounts should be ignored.

This ownership agreement is unique in that the level of value differs based not on the size or attributes of the subject ownership interest, but rather on the circumstance under which the owner withdraws (i.e., voluntarily versus upon death).

Although the standard of value is clearly defined, the ownership agreement leaves some ambiguity with regard to the premise of value. The subject ownership agreement states that the fair market value of the company is "the amount that could reasonably be expected to be realized upon sale." It is not clear whether the hypothetical sale would reflect:

1. value as a going concern or
2. value in liquidation (if appropriate).

If the company's net asset value exceeds its value as a going concern, a legitimate question may arise regarding the appropriate premise of value to consider. The subject ownership agreement states the fair market value of the company, not the subject interest, is the starting point for the determination of "value."

However, if the subject interest is a noncontrolling ownership interest, then is the "value" of the individual assets relevant? If so, is the "reasonable sale price" based on forced liquidation, or should the "reasonable sale price" reflect an orderly disposition?

Qualifying the level of value to be used based on the nature of the triggering event may also lead to disagreement between the selling owner and the remaining owner(s). If a sale is triggered due to disability or another unavoidable event, should a discount for lack of control and a discount for lack of marketability still be applied?

Example 3

The definition of "value" incorporated in an ownership agreement may be used as a tool—advertently or inadvertently— to:

1. benefit the seller of an ownership interest (i.e., no allowable discounts),
2. benefit the buyer of an ownership interest (i.e., mandatory discounts), or
3. discourage the sale or transfer of ownership interests.

The following excerpt from an ownership agreement illustrates how the definition of "value" can be used to discourage certain types of transfers and benefit the remaining owner(s) (i.e., buyers).

> In the event any shareholder's shares are involuntarily transferred to any nonshareholder person or entity, without written consent of the other shareholders of the corporation, the transferee will be obligated to sell, and the corporation will have the right to purchase, all or a portion of the involuntary transferred shares. This provision will not apply to a transfer by a shareholder to a revocable trust controlled by the shareholder, nor a transfer by operation of law on the shareholder's death.
>
> Under this paragraph, the purchase price will be determined by the following formula:
>
> - The value of the assets of the corporation will be determined at **book value, without any weight given to going-concern value or goodwill, and taking into consideration any accumulated depreciation** ("asset value").

- The total amount of current and long-term liabilities will then be deducted from the asset value, resulting in a "net asset value."
- Net asset value will then be **reduced by 50%**, and from this figure, the pro rata value of the involuntarily transferred shares ("purchase price") will be determined.

In this example, the formula for determining "value" is defined. It is also clear that the definition of "value" as described in this example is used as a tool to discourage involuntary transfers of ownership interests.

There have been multiple court cases that have supported the use of book value to determine a purchase price, even if that value differs significantly from the fair value or fair market value of the subject ownership interest.

One deciding factor in these court cases was that the definition of "value" is clearly defined in the subject ownership agreement as book value.

This was the case in (1) *Estate of Maurice F. Frink v. Flowerama of America, Inc.*;[10] (2) *Tynes E. Mixon, III, M.D., v. Iberia Surgical LLC*;[11] and (3) *Estate of Cohen v. Booth Computers and James S. Cohen*.[12] In each of these court cases, the court upheld that book value was the appropriate definition of "value" to use in determining price, even though the resulting price was significantly lower than if calculated on a fair market value basis.

In each of these cases, the court cited a clearly defined standard of value (book value) in the subject ownership agreement as a reason for its decision.

Example 3 and the court cases cited above illustrate how defining "value" can be used by founding owners to serve a specific interest that otherwise may not be appropriate or defensible under generally accepted valuation practices.

Conclusions

Founding owners of an entity are free to define "value" in any legal manner desired. The definition of "value" incorporated in an ownership agreement, if not appropriately considered and structured, may inadvertently benefit the seller of an ownership interest to the detriment of the buyer, or inadvertently benefit the buyer of an ownership interest to the detriment of the seller.

As noted in example 3, the founding owners of an entity may even use the definition of "value" to discourage or encourage certain types of sales.

The definition of "value" incorporated in an ownership agreement should reflect the long-term intent of the founding owners. However, the founding owners drafting the ownership agreement may consider the likelihood that they ultimately may leave and new owners may join.

Founding owners should also keep in mind that unless specifically defined, the term "fair market value," when left to qualified valuation analysts, will be estimated based on consideration of generally accepted valuation practice, as influenced by the facts and circumstances unique to the transaction under consideration.

"The definition of 'value' incorporated in an ownership agreement, . . . may inadvertently benefit the seller of an ownership interest to the detriment of the buyer, or inadvertently benefit the buyer of an ownership interest to the detriment of the seller."

In order for owners to maintain control over transactions and realize their intent, it is important that an ownership agreement clearly defines "value" in all key respects, including:

1. the standard of value,
2. the premise of value, and
3. the level of value.

Further, clarity in an ownership agreement may be enhanced if it gives illustrative examples regarding how the definition of "value" is intended to be applied.

As presented in examples 1 and 2, even when the definition of "value" is well thought out and defined, there is still room for interpretation, and, therefore, potential dispute.

As external (e.g., economic and industry) and internal (e.g., aging owners and changing employees) circumstances evolve and change, the need for potential modifications to definitions and interpretations of "value" may develop, regardless of diligence and thought incorporated in an original ownership agreement.

Dissenting owners can argue the intent, or original definition of "value" incorporated in an ownership agreement, is no longer relevant or fair based on a change in circumstances.

One useful method to minimize the potential for conflict relating to the buyout provision in

an ownership agreement is to engage a qualified, independent advisory team—represented by a valuation analyst and legal counsel—to analyze owner intent and complete a valuation based on a clearly stated definition of "value."

Completing such a process prior to the development of an ownership agreement (or redemption) may provide valuable information for the parties that should better enable them to reflect their intentions in the agreement and adhere to consistent redemption practices after the consummation of the agreement.

By preemptively performing a valuation, the owners and interested parties can provide input prior to conflicts of interest clouding the debate. The valuation process can then be repeated in a consistent manner at defined intervals, minimizing the potential for dispute at the time a triggering event occurs.

Notes:

1. American Society of Appraisers, Business Valuation Standards – Definitions.
2. *The Appraisal of Real Estate*, 11th ed. (Chicago: Appraisal Institute, 1996), 638.
3. Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business*, 4th ed. (New York: McGraw-Hill, 2000), 31.
4. Model Business Corporation Act § 13.01(3)(ABA 1984).
5. Pratt, Reilly, and Schweihs, *Valuing a Business*, 33.
6. Ibid.
7. Ibid.
8. Ibid.
9. Estate of Maurice F. Frink v. Regions Bank, et al., 725 N.W.2d 658 (Iowa Ct. App. 2006).
10. Ibid.
11. Mixon v. Iberia Surgical, L.L.C., 956 So.2d 76 (La. Ct. App. 2007).
12. Estate of Cohen, ex. rel. Perelman v. Booth Computers, 22 A.3d 991 (N.J. Super. Ct. App. Div. 2011).

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Entity-Level vs. Ownership-Level

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As a result, in a fair value context for a dissenter case, it may be necessary to identify whether including or excluding a conglomerate discount is likely to unjustly benefit one party or the other. Ideally, the ultimate value impact on all parties should be equitable.

Conclusion

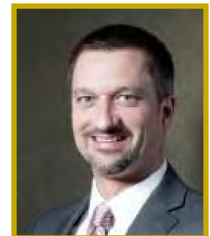
The fair value standard in a dissenter case often presents a number of valuation considerations specific to the engagement that are not necessarily present in a "standard" valuation engagement.

First, it is important to understand the relevant state statute and court precedents that may affect the current engagement.

Second, it may be necessary to recognize potential valuation adjustments as entity-level or ownership-level adjustments, and then identify whether the inclusion of an adjustment is appropriate based on the applicable fair value definition and the facts and circumstances of the particular engagement.

Third, it is important to understand that certain entity-level discounts may be appropriate under a fair value standard and to properly apply the necessary methods to quantify a reasonable valuation adjustment.

Finally, consideration may be given to analysis of the concluded results from both a dissenting shareholder and a nondissenting shareholder perspective in order to establish the reasonableness of economic returns afforded to both parties.



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We provided business valuation and
expert testimony services to
King & Spalding LLP
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We provided business valuation and
expert testimony forensic analysis to
Sidley Austin LLP
in a shareholder oppression
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***Thought Leadership
in the Valuation of Businesses, Business Interests, and Securities***

The Deal That Allegedly Never Died: Defending Against a Claimed Option to Purchase

Alexander C. Chae, Esq., and Audrey F. Momanaee, Esq.

The case of M7 Capital, LLC, v. Ted Miller*, which was tried in late 2013, is an example of the jury getting it right. In that case, the plaintiff, M7 Capital, LLC ("M7 Capital"), by and through its principal, John Miller, claimed to have a perpetual option to purchase an ownership interest in a company. The trial, which involved the theatrics of a crying John Miller of M7 Capital, lasted two weeks, and resulted in a verdict for Ted Miller, with M7 Capital taking nothing. In the case, the jury did not decide the value of the company at issue. This is because the jury found that there was no agreement to hold the purchase option indefinitely. Had the jury found the existence of such an agreement, however, issues of the appropriate valuation would have been paramount.*

The Facts of the Case

In the fall of 2002, Ted Miller, the former president, chief executive, and founder of Crown Castle, was approached by John Miller, a former chief executive of a publicly traded company and a Louisiana-based promoter, about coinvesting in an aircraft parts business in San Antonio and Virginia that was in bankruptcy.

The business opportunity that was initially proposed involved the purchase, out of bankruptcy, of the assets of three U.S. divisions of Fairchild Dornier. Fairchild Dornier was a manufacturer of turboprop-powered aircrafts that are primarily used by commuter airlines.

The three divisions in bankruptcy, Merlin Express Incorporated, Fairchild Gen-Aero Incorporated, and Metro Support Services, Inc., operated the Fairchild Dornier U.S. servicing and parts distribution center in San Antonio (the "FDUS Assets").

Ted Miller, on behalf of 4M Investments (an entity controlled by Ted Miller), successfully bid for the FDUS Assets in an agreement dated December 17, 2002. The purchase price of the FDUS Assets was $7.4 million. The interest in the FDUS Assets was later assigned to M7 Aerospace LP, an entity controlled by Ted Miller.

In January 2003, due diligence was conducted on the feasibility of the purchase of assets that were owned by another subsidiary of Fairchild Dornier named Dornier Aircraft North America ("DANA Assets"). In February 2003, Ted Miller, on behalf of M7 Aerospace LP, made a successful bid in a Virginia bankruptcy court for the DANA Assets.

The purchase price of the DANA Assets was $5.6 million. The interest in the DANA Assets was later assigned to M7 Aerospace II LP, an entity controlled by Ted Miller.

Ted Miller formed M7 Holdings on or about March 24, 2003. M7 Holdings held a 99.0 percent limited partnership interest in the following entities:

- M7 Aerospace LP
- M7 Aerospace II LP

Though he indicated an interest in doing so, because John Miller did not provide any capital to co-purchase the FDUS Assets and the DANA Assets, Ted Miller and his entities were forced to provide $3.5 million of investment capital and to guarantee

a $10 million loan from JP Morgan Chase in order to make the purchases.

From December 2002 to June 2003, John Miller and Ted Miller discussed various scenarios under which M7 Capital, an entity formed by John Miller, may acquire an interest in M7 Holdings and in the FDUS Assets and DANA Assets. During this time, John Miller was employed by M7 Holdings and was paid $200,000 per year.

There was never any limited partnership or other written agreement between John Miller and Ted Miller or their respective entities. Further, neither John Miller nor M7 Capital, ever paid any consideration to Ted Miller or M7 Holdings for any ownership interest in M7 Holdings.

In a June 27, 2003, email, John Miller was notified that if he wished to proceed with the purchase of an interest in M7 Holdings, Ted Miller's attorney must have written confirmation of payment by no later than 5:00 p.m. on June 30, 2003. Nothing was received by M7 Holdings at that time.

However, at trial, John Miller testified that on or about June 30, 2003, $750,000 was placed in an escrow account, allegedly on behalf of M7 Capital, to purchase a 20.48 percent ownership interest in M7 Holdings.

On July 10, 2003, and again on July 11, 2003, John Miller informed Ted Miller that he would not be moving forward with the purchase of the ownership interest in M7 Holdings.

Under Ted Miller's leadership, the newly formed company became very successful. And, in 2007, Ted Miller sold the company for a significant gain on his investment.

M7 Capital then filed suit, alleging that it was owed a share of the company's sale price. M7 Capital, through John Miller, claimed that he had identified and analyzed the business opportunity on his own time and proposed to Ted Miller that they should purchase the FDUS Assets out of bankruptcy. John Miller further claimed that around December 2, 2002, he and Ted Miller agreed that Ted would own at least a 51 percent controlling interest in the acquiring limited partnership, while an investment entity to be formed by John Miller would have the option to purchase up to a 49 percent ownership interest.

M7 Capital further claimed that on June 30, 2003, John Miller deposited $750,000 into an escrow account representing payment for a 20.48 percent interest in the limited partnership, but that before the deal closed, Ted Miller amended a proposed limited partnership agreement. According to M7 Capital, the amended agreement contained unacceptable terms to John Miller and his investors, which made it impossible for him to exercise his option to purchase an interest, even though he was ready, willing, and able to do so as of June 30, 2003.

The trial court granted a motion for summary judgment on failure of consideration grounds in favor of Ted Miller. However, the appellate court subsequently overturned the summary judgment.

Upon returning to the trial court, M7 Capital proceeded with claims of breach of contract and fraud, seeking over $21 million based, in part, on its expert's valuation of 20.48 percent of M7 Holdings at $5.8 Million.

Ted Miller moved for summary judgment on the fraud claims in the case. However, the court allowed that claim, along with the breach of contract claim, to proceed to trial.

On December 12, 2012, after a two week trial presided over by Judge Mike Miller in the 11th Judicial District Court of Harris County, the jury entered a verdict in favor of Ted Miller, finding no fraud in Ted Miller's actions. The jury also found that no contract had ever been created between Ted Miller and M7 Capital with the terms that M7 Capital had alleged.

The Valuation

Though it became moot by the jury's findings, had the jury found the existence of a contract between Ted Miller and M7 Capital, the issue of damages would have been important. The two valuation analyst opinions on damages diverged. The court selected a valuation date as of July 9, 2003, which was the day prior to the date of the alleged breach.

Ted Miller's Valuation Analyst

The valuation analyst for Ted Miller valued the alleged loss of a 20.48 percent interest in M7 Holdings using both an asset-based and a market-based approach. The expert determined that the value of such interest was less than $700,000 given the results of the valuation under each of these approaches.

Using the asset-based approach, and valuing the assets of M7 Holdings as of July 9, 2003, the value of 100 percent of the M7 Holdings equity was $4,419,074. M7 Holdings acquired the tangible assets approximately three months prior to the valuation date. This equity value represented the amount that was paid to purchase these assets out of bankruptcy less debt financing used for the asset acquisitions. Reducing this value by a 20 percent discount for lack of marketability and a 15 percent discount for lack of control resulted in a value of $615,000 for a 20.48 percent interest in M7 Holdings.

Using the market approach and considering other transactions in the M7 Holdings ownership interests, which occurred from April through September of 2003, the defendant's valuation analyst estimated that the fair market value of a 20.48 percent interest in M7 Holdings was $724,000.

The M7 Capital Valuation Analyst

Not surprisingly, the valuation analyst for M7 Capital estimated the value of M7 Holdings to be far greater, estimating the value of a 20.48 percent interest in M7 Holdings at $5.849 million. The valuation conclusion from the plaintiff's analyst was approximately $35 million higher than the actual price paid by the defendant for the assets.

In his valuation, the plaintiff's analyst used the income approach based on defendant's business plan. The analyst also concluded that (1) the asset approach did not "reflect fair market value" because the assets were purchased out of bankruptcy at a discount and (2) there was not any transaction data available to apply a market approach analysis.

The plaintiff's analyst assumed that there was minimal risk with future cash flow even though the four entities were acquired by M7 Holdings through bankruptcy and had only been operated by M7 Holdings for three months. The business plan included significant changes in operating structure.

In his income approach analysis, and assuming annual earnings before interest, taxes, depreciation, and amortization (EBITDA) of $6 million and an aggressive capitalization rate that was equivalent to an earnings multiple of 7, the plaintiff's analyst estimated the business value to be $42 million. After applying a 20 percent discount for lack of control and a 15 percent discount for lack of marketability, the M7 Capital analyst estimated that the fair market value of a 20.48 percent interest in M7 Holdings was $5,849,190.

Importantly, in his valuation, the plaintiff's analyst relied on data from transactions involving M7 Holdings that occurred in December 2003, well after the valuation date in the case. Legal counsel for Ted Miller argued the impropriety of relying on such data based on the AICPA *Statement on Standards for Valuation Services*, which expressly requires, among other things, that "the valuation analyst should only consider circumstances existing at the valuation date and events occurring up to the valuation date . . ." Nevertheless, the court allowed the testimony, subject to cross-examination, to be presented to the jury.

Conclusion

At the end of the day, the jury found in favor of Ted Miller, finding that no contract with a perpetual option existed between the parties, as alleged by M7 Capital.

Though the issue of value was never decided by the jury, from the perspective of the defendant, given the risk associated with the M7 Holdings assets and what was known at the time of the purchase of those assets out of bankruptcy, the proper valuation analysis was that prepared by the defendant's analyst. This analyst estimated the value of the company as of June 2003, and he did not consider future unknown events. Though it was not ultimately something that the jury relied upon in making their determination, we believe that the straightforward and reasonable nature of the analysis would have won the day.

Alexander C. Chae is a trial partner of Gardere Wynne Sewell LLP. Mr. Chae's practice encompasses all areas of commercial litigation. Recently, Mr. Chae's trial skills in the courtroom resulted in a successful $27.3 million victory on behalf of Curocom Energy LLC after a three-week trial. This multi-million dollar verdict was recognized as one of the National Law Journal's *"Top 100 Verdicts of 2014." He was proud to represent Ted Miller in the M7 Capital case, alongside his co-counsel Robert Singleton Jr. of Singleton Cooksey PLLC and Audrey F. Momanaee of Gardere Wynne Sewell LLP. Mr. Chae can be reached at (713) 276-5539 or at achae@gardere.com.*

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Valuation of Health Care Entity Property or Services Transfers

Robert F. Reilly, CPA

Health care providers comply with a myriad of professional regulations. Health care providers also comply with a myriad of administrative regulations. This is because most health care providers are regulated by—and receive reimbursements for their professional services from—numerous government organizations. Such health care provider entities are subject to the regulatory regime of the various Medicare fraud and abuse statutes and the various Stark statutes. In addition, tax-exempt health care entities are subject to regulation by the Internal Revenue Service and by state attorneys general. Valuation analysts ("analysts") consider this regulatory environment when health care entities enter into transactions related to the transfer of property (e.g., the purchase of a professional practice or hospital) or the payment for services (e.g., an employment agreement or professional services agreement). This is because analysts are called on by the parties to such a health care property or services transfers. The analysts are asked to perform fair market value valuations related to the proposed health care transaction. This discussion summarizes what analysts (and transaction participants) need to know about the fair market value valuation of health care entity transfers of property or services.

Introduction

This discussion describes many of the regulatory reasons why a health care entity may retain a valuation analyst ("analyst") to perform:

1. a property transfer (e.g., purchase of a clinic or professional practice) transaction valuation,
2. a services transfer (e.g., reasonableness of compensation) transaction valuation, or
3. some other type of fair market value valuation analysis.

The first section of this discussion considers tax regulations regarding the valuation of tax-exempt health care property or services transfers.

The second section of this discussion considers nontax regulatory issues regarding the valuation of health care property or services transfers.

The last section of this discussion describes several analyst misconceptions regarding the valuation of health care property or services transfers.

Tax-Exempt Entity Valuation Issues

The private inurement and excess benefit issues regarding tax-exempt health care entities cover two types of transfers: (1) property and (2) services. Both transaction types should be analyzed to conclude a fair market value opinion related to the transfer.

The term "fair market value" is defined the same way for both property and services transfers in Treasury Regulation 53.4958-(b)(1)(i):

> Fair market value is defined as the price at which property or the right to use property would change hands between a willing

buyer and a willing seller, neither being under any compulsion to buy, sell, or transfer property or the right to use property and both having reasonable knowledge of relevant facts.

Most analysts are familiar with property transfer valuations. This transaction type occurs when the tax-exempt entity buys or sells a business entity, a business ownership interest, or business operating assets.

Common examples of such property transfers include the tax-exempt health care entity buying (or selling) the equity—or the assets—of a hospital, clinic, physician practice, outpatient surgical center, dialysis center, MRI center, urgent care center, HMO, home health care agency, medical equipment provider, or any other health care/provider delivery organization. These property transfer transactions may include the purchase or sale of either the assets or the equity of the health care provider entity.

Such property transfers may include the tax-exempt entity either buying or selling a medical office building, specialty medical equipment, or other type of real estate or tangible personal property.

As part of the tax-exempt entity transaction, the analyst may be asked to opine on the fair market value of the property transfer.

Some analysts are less familiar with services transfer valuations. This transaction type occurs when the tax-exempt entity hires employees or contracts for professional services.

Common examples of such services transfers occur when the tax-exempt health care entity compensates a chief executive officer (CEO) or other executives, pays a medical director (or other physician professionals), hires a physician group to manage emergency room or operating room operations, rents office or professional space to (or from) physicians, leases equipment to (or from) physicians, provides billing or other administrative services to physicians (or from other for-profit service providers), or generally enters into any joint venture or related contractual agreement with physicians or other health care providers.

As part of the tax-exempt entity transaction, the analyst may be asked to opine on the fair market value of the services transfer.

The private inurement prohibition requires that a public charity that has tax-exempt status under Internal Revenue Code Section 501(c)(3) operate so that none of its income or assets unreasonably benefits any of its board members, trustees, officers, or key employees. These individuals are commonly referred to as "insiders."

The private inurement prohibition precludes any tax-exempt entity income or assets from unfairly or unreasonably benefiting (either directly or indirectly) individuals who have:

1. close relationships with the entity and
2. the ability to exercise control over the entity.

A common type of private inurement is excessive compensation paid to insiders. Private inurement can result in:

1. the revocation of the health care entity's tax-exempt status or
2. the imposition of significant "intermediate sanctions" (discussed below).

Private inurement can result from transactions related to:

- the sale of the tax-exempt entity's asset to an insider;
- the entity's purchase of an asset from an insider;
- the entity's rental of real estate or tangible personal property from, or to, an insider;
- the entity's lending of money to an insider; and
- the use of the tax-exempt entity facilities and/or any other assets by an insider.

The principal factor in assessing whether a tax-exempt entity transaction with an insider violates the private inurement prohibition is whether the transaction is fair and reasonable under the circumstances. For example, it is not inappropriate for a tax-exempt hospital to buy a medical office building from a physician group at, or below, its fair market value. However, it is inappropriate for the tax-exempt hospital to lease the medical office building to a physician group for less than its fair market value rent.

Individuals working for a tax-exempt health care entity expect to be reasonably compensated. Such individuals are not expected to accept reduced compensation simply because they provide services to a tax-exempt entity rather than to a taxable entity. The private inurement regulations simply require that the total compensation paid by a tax-exempt entity to an insider be fair and reasonable.

Whether compensation is fair and reasonable is determined on a case-by-case basis. A fair market

value compensation analysis involves procedures similar to those used to value any other services transfer. This compensation valuation requires the analyst to gather comparable data regarding what similarly situated individuals employed by similar organizations are paid.

The analyst typically considers the following factors in the compensation valuation:

- The compensation paid by similar entities, both tax-exempt and taxable, for equivalent positions in the same geographic area
- The tax-exempt entity's need for the particular services of the individual
- The uniqueness of the individual's background, education, training, experience, and responsibilities
- Whether the compensation was approved by an independent board of directors
- The size and complexity of the entity's income and assets and the number of employees that the entity employs
- The individual's prior compensation arrangements, the individual's job performance, and the relationship of the individual's compensation to the compensation paid to the entity's other employees
- The number of hours that the individual spends performing his or her job

Total compensation paid by a tax-exempt health care entity to an insider includes more than just salary or wages. It also includes all forms of compensation, such as bonuses, commissions, royalties, fringe benefits, deferred compensation, severance payments, retirement and pension benefits, expense allowance, and insurance benefits.

An unreasonably large or excessive salary paid by a tax-exempt entity to an insider can be considered private inurement. Private inurement can occur when the insider also receives other forms of compensation from the tax-exempt entity.

The tax-exempt health care entity can avoid private inurement issues regarding the compensation it pays to an insider as long as the entity is able to do the following:

- Describe fully and accurately all aspects of the insider's total compensation package
- Explain exactly how the entity determined the insider's total compensation package
- Describe adequately and accurately the insider's duties and responsibilities
- Provide adequate documentation, such as comparable salaries paid by similar entities, that demonstrate the reasonableness of the insider's compensation
- Demonstrate through appropriate documentation that the entity's governing body approved the amount of the insider's compensation and that the insider (or someone related to the insider) did not participate in the approval process
- Demonstrate that the amount of the insider's total reportable compensation agrees with the amount reported on the insider's Form W-2 or Form 1099—in order to avoid an automatic excess benefit transaction
- Demonstrate through appropriate documentation that the insider's use of any of the entity assets (such as cars, real estate, credit cards, laptops, or cell phones) for any reason other than fulfilling the entity's tax-exempt purpose, were properly included in his or her compensation and properly included in the insider's Form W-2 or Form 1099—in order to avoid penalties for automatic excess benefit transactions

In an excess compensation case, the "excess benefit" is the amount by which (1) the total compensation paid by the tax-exempt entity to the insider exceeds (2) the reasonable value of the services provided by the insider.

If a comparison of comparable executive salaries indicates that the tax-exempt hospital CEO is being paid $100,000 more than comparable individuals performing similar functions at similar hospitals (and that there is no legitimate reason for such excess compensation), then the amount of the "excess benefit" received by the insider would be $100,000.

Section 4958(a)(1) imposes an initial tax equal to 25 percent of the excess benefit. In this example, the CEO insider (i.e., not the tax-exempt hospital itself) would have to pay a $25,000 penalty to the Service. In addition, the CEO insider would have to make the hospital whole by repaying the $100,000 excess benefit, plus interest.

If the CEO insider does not make the tax-exempt hospital whole within the time frame set by the Service, Section 4958(b) imposes an additional tax equal to 200 percent of the excess benefit of the CEO insider—that is, an additional $200,000 tax penalty in this example.

Section 4958(a)(2) also imposes a tax equal to 10 percent of the excess benefit on any tax-exempt entity executive, typically a board member who knowingly approved the excess benefit transaction, unless his or her participation was not willful. In

the above example, the tax on any hospital board member who knowingly approved the unreasonable or excessive CEO salary would be $10,000.

It is important to note that the term "participation" includes a board member's silence or inaction where he or she is under a duty to speak or act—as well as any affirmative action by the board member. The board member is not considered to participate in an excess benefit transaction, however, if he or she opposed the transaction. For example, the board member could have his or her objection to the compensation transaction noted in the board meeting minutes.

The board member's participation will not normally be considered to be "knowing" within the meaning of Section 4958(a)(2) if there was full disclosure of all relevant facts to an appropriately qualified analyst and the board member relied on a reasoned written opinion by that analyst that the subject payment was reasonable.

To help tax-exempt entities comply with these regulations, the Service established a "rebuttable presumption" that payments to insiders are presumed to be reasonable and not excessive if the following procedures are performed:

- The tax-exempt entity's board obtains and relies on appropriate comparability data prior to making its determination.
- The total compensation package is approved in advance by the tax-exempt entity's board, and no individuals who have an actual or potential conflict of interest with respect to the compensation arrangement participates in the deliberations.
- The tax-exempt entity's board adequately and contemporaneously documents the basis for its determination.

If the above procedures are performed, the Service may only rebut the presumption of reasonableness if it can demonstrate that the comparability data relied on by the board was inappropriate. For a tax-exempt entity with annual gross receipts of less than $1 million, a board is considered to have appropriate comparability data if it has data on compensation paid for similar services by three comparable organizations in the same or similar communities.

All Health Care Entity Valuation Considerations

All health care entities (tax-exempt or otherwise) comply with numerous other federal and state regulations regarding property or services transfers. This section summarizes the regulatory considerations regarding the valuation of such transfers.

There are numerous federal laws that govern Medicare fraud and abuse. Most of the statutory provisions do not encompass property or services transfers. The analyst does not have to be familiar with most of these laws. Health care providers should be familiar with—and comply with—all of these laws. In this discussion, these laws are referred to collectively as the Medicare fraud and abuse statutes (or, simply, the statutes).

These statutes include the following:

1. The False Claims Act
2. The Anti-Kickback Statute
3. The Physician Self-Referral Law
4. The Social Security Act
5. The United States Criminal Code

These statutes specify the criminal and/or civil remedies that can be imposed on individuals or provider entities that commit fraud and abuse in the Medicare Program, including Medicare Parts C and D, as well as the Medicaid Program. Violations of any of these statutes may result in the nonpayment of claims, civil monetary penalties, exclusion from participation in federal health care programs, and criminal and civil liabilities. A health care provider can be liable without any actual knowledge or a specific intent to violate the law.

These statutes are introduced below.

The False Claims Act

The False Claims Act protects the government from being overcharged or sold substandard goods or services. The False Claims Act imposes civil liability on any "person" who knowingly submits, or causes the submission of, a false or fraudulent claim to the federal government. The "knowing" standard includes acting in deliberate ignorance of—or reckless disregard of—the truth related to the claim.

In addition, there is a criminal False Claims Act statute through which an individual or entity health care provider that submits false claims can face criminal penalties.

The Anti-Kickback Statute

The Anti-Kickback Statute makes it a criminal offense to knowingly and willfully offer, pay, solicit, or receive any remuneration (directly or indirectly) to induce or reward referrals of items or services reimbursable by a federal health care program.

An example of an Anti-Kickback Statute violation would be a health care provider who benefits from a below fair market value rent on a hospital-owned medical office building in exchange for patient referrals.

Civil penalties for violating the Anti-Kickback Statute can include fines up to three times the amount of kickback. Criminal penalties for violating the Anti-Kickback Statute can include fines, imprisonment, or both.

If certain types of health care provider arrangements satisfy a regulatory safe harbor, then the Anti-Kickback Statute will not treat such an arrangement as an offense.

Physician Self-Referral Law (Stark Law)

The Physician Self-Referral Law, often called the Stark Law, prohibits a physician from making a referral for certain designated health services (DHS) to a health care provider entity:

1. in which the physician (or member of his or her immediate family) has an ownership/investment interest or
2. with which he or she has a compensation arrangement, unless an exception applies.

The Stark Law is discussed below.

Criminal Health Care Fraud Statute

The Criminal Health Care Fraud Statute prohibits knowingly and willfully executing, or attempting to execute, a scheme or artifice in connection with the delivery of or payment for health care benefits, items, or services to:

1. defraud any health care benefit program or
2. obtain (by means of false or fraudulent pretenses, representations, or promises) any of the money or property owned by, or under the custody or control of, any health care benefit program.

Other Medicare Fraud and Abuse Penalties

In addition to the civil and criminal actions brought by law enforcement agencies, the Medicare Program has administrative remedies applicable for certain health care fraud and abuse violations.

Under the Exclusion Statute, the Department of Health and Human Services (HHS) Office of Inspector General (OIG) will exclude from participation in all federal health care programs any health care providers and suppliers that are convicted of:

1. Medicare fraud;
2. patient abuse or neglect;
3. felony convictions related to fraud, theft, embezzlement, breach of fiduciary responsibility, or other financial misconduct in connection with the delivery of a health care item or service; or
4. felony convictions for unlawful manufacture, distribution, prescription, or dispensing of controlled substances.

The OIG has discretion to impose exclusions on a number of other grounds. Excluded providers cannot participate in federal health care programs for a designated period. An excluded health care provider may not bill federal health care programs (including, but not limited to, Medicare, Medicaid, and State Children's Health Insurance Program) for services he or she orders or performs. At the end of an exclusion period, an excluded health care provider must affirmatively seek reinstatement. Reinstatement is not automatic.

Under the Civil Monetary Penalties Law, civil monetary penalties apply for a variety of misconduct. The Civil Monetary Penalties Law authorizes penalties of up to $50,000 per violation, and assessments of up to three times the amount claimed for each item or service, or up to three times the amount of remuneration offered, paid, solicited, or received.

Health care provider violations that may result in a civil monetary penalty include:

1. presenting a claim that the health care provider knows or should know is for an item or service not provided as claimed or that is false and fraudulent,
2. presenting a claim that the health care provider knows or should know is for an item or service for which Medicare will not pay, and
3. violating the Anti-Kickback Statute.

The Medicare fraud and abuse statutes make it illegal to pay, offer, or induce any remuneration in exchange for patient referrals. For example, a hospital cannot pay a physician in exchange for patient referrals to that hospital. In a physician practice acquisition, a hospital cannot pay any portion of the purchase price in exchange for the physician's current or expected patient referrals to that hospital.

Therefore, neither tax-exempt nor taxable health care acquirers should structure transactions that appear to involve either (1) a "kickback" payment

for physician patient referrals or (2) a "lockup" of physician patient referrals.

The various Stark laws prohibit physicians with a financial relationship with a health care entity from referring patients to the entity for DHS covered by either Medicare or Medicaid programs. The Stark laws are named for United States Congressman Peter Stark who sponsored the initial bill.

The Stark laws provide a limitation on certain physician referrals. The law prohibits physician referrals of DHS for Medicare and Medicaid patients if the physician (or an immediate family member) has a financial relationship with that health care entity. A financial relationship is defined to include ownership, investment interest, and compensation arrangements.

Under the Stark laws, the term "referral" is defined more broadly than merely recommending a vendor of DHS to a patient. Instead, the Stark laws definition of the term "referral" means, for Medicare Part B services, "the request by a physician for the item or service" and, for all other services, "the request or establishment of a plan of care by a physician which includes the provision of the designated health service."

The term DHS is defined to include clinical laboratory services as well as the following: physical-therapy services; occupation-therapy services, radiology, including magnetic resonance imaging, computerized axial tomography scans, and ultrasound services; radiation-therapy services and supplies; durable medical equipment and supplies; parenteral and enteral nutrients, equipment, and supplies; prosthetics, orthotics, and prosthetic devices; home health services and supplies; outpatient prescription drugs; and inpatient and outpatient hospital services.

The Stark laws contain several exceptions. The statutory exceptions include physician services, in-office ancillary services, ownership in publicly traded securities and mutual funds, rental of office space and equipment, bona fide employment relationships, and the like.

The Stark penalties include the following:

1. Denial of payments for the DHS provided
2. Refund of any monies received by physicians and facilities for amounts collected, payment of civil penalties of up to $15,000 for each health care service that a person "knows or should know" was provided in violation of the Stark laws, and three times the amount of improper payment the health care entity received from the Medicare program
3. Exclusion from the Medicare program and/or state health care programs including Medicaid

4. Payment of civil penalties for attempting to circumvent the Stark laws of up to $100,000 for each circumvention scheme

The Medicare anti-kickback laws prohibit both the giving and the receipt of anything of value to induce the referral of medical business reimbursed under the Medicare or Medicaid programs. Unlike the Stark laws, the Medicare anti-kickback law is an "intent-based" statute.

The Medicare anti-kickback law statutes make it clear that the health care entity payments for any property or services should be based on a fair market value price (and not on a variable formula, such as a patient volume or patient referrals formula).

The Stark II statute became effective on January 1, 1995. Like the Stark I statute (which became effective on January 1, 1992), Stark II was intended to curb abuses inherent in physician self-referral arrangements. Like Stark I, Stark II prohibits physicians who have a financial relationship with a health care entity (whether tax-exempt or taxable) from referring patients to the entity for DHS covered by either Medicare or Medicaid programs.

A financial relationship consists of (1) an ownership or investment interest in the health care entity or (2) a compensation arrangement with the health care entity. There is no financial relationship if the physician does not:

1. own any portion of the health care entity and
2. pay the health care entity or receive any kind of payment from the entity for the referral or for anything else.

Under the various Stark laws, a financial relationship can exist between a physician and a health care entity even if that relationship does not involve DHS or the Medicare or Medicaid programs.

A compensation arrangement is defined in the Stark II statute as any arrangement involving any remuneration between (1) a physician (or family member) and (2) a health care entity. This remuneration can involve payments for anything, such as payments for rent, payments for nonmedical services, or payments for housing or travel expenses.

The Stark statutes would interpret the purchase of a physician's practice by a hospital (and the related payment to the selling physicians) as a financial arrangement.

Section 18779(e)(6) of the Stark II regulations provides that an isolated transaction, such as a one-time sale of property (such as a professional practice), is not considered a compensation arrangement for purposes of the prohibition on patient referrals.

This prohibition does not apply if the following conditions are met:

- The amount of remuneration for the one-time transaction sale is consistent with fair market value and is not determined, directly or indirectly, in a manner that takes into account the volume or the value of physician patient referrals.
- The remuneration is provided under an agreement that would be commercially reasonable even if no patient referrals are made to the acquirer health care entity.
- The arrangements meet any other requirements the Secretary (of Health and Human Services) may impose by regulation as needed to protect against Medicare program or patient abuse.

The term "isolated transaction" is defined as a transaction involving a single payment between two or more persons. A transaction that involves long-term or installment payments Is not considered to be an isolated transaction.

To comply with the various Stark laws, any health care entity property or practice purchase should be:

1. priced at fair market value and
2. structured with a purchase price that is not paid in patient referral-related installments.

To comply with the various Stark laws related to the payment for services, any health care entity services transfer should be structured as follows:

1. There should be a written agreement signed by parties that specified the services to be covered under the arrangement.
2. The term of the agreement should be specified.
3. The aggregate services contracted for should not exceed those that are reasonable and necessary for the legitimate business purpose of the subject arrangement.
4. The compensation to be paid by the health care entity over the term of the agreement should be:
    a. defined in advance,
    b. not in excess of fair market value, and
    c. not determined in a manner that takes into account patient volume or the value of any patient referrals or other business generated by the parties.

The Phase III final rule of Stark II became effective on December 4, 2007 (except for certain "stand in the shoes" provisions described below—which became effective on December 4, 2008). And, the Center for Medicare and Medicaid Services (CMS) self-referral disclosure protocol rules (described below) were published on September 23, 2010.

The Phase III final rules are sometimes referred to as the Stark III regulations. These Stark III regulations (and particularly the transaction and valuation provisions) are summarized below:

1. The "stand in the shoes" provision. A physician's relationship with an entity providing designated health services (such as a hospital) through a direct single intervening physician organization (such as a group practice) may no longer take advantage of the favorable provisions of the Stark laws indirect compensation exception.

    Under Stark III, a physician is considered to "stand in the shoes" of his or her physician organization. Therefore, the relationship between the physician organization itself and the entity providing DHS must meet a Stark law exception.

    In making this rule change, the Stark III regulations tighten the indirect compensation exception. The indirect compensation exception is still available for compensation relationships where there is more than one entity between (a) the provider of DHS and (b) the physician.

    But this is only the case as long as the physician is paid in a manner that does not reflect the volume or value of patient referrals to the health care entity providing the DHS.
2. Shared space. To the extent that a physician or practice relies on the Stark law "in office" ancillary services exception to provide DHS

to patients (such as imaging or clinical lab services), such services must be (a) provided in office or (b) leased on a block-time basis, rather than a per-click basis.

3. Independent contractors. A group practice that obtains the services of an independent contractor physician (such as a pathologist or radiologist) in connection with the provision of designated health services must contract with that physician directly.

   Contracting with the physician's practice or with a staffing service will not allow the group practice to bill for the independent contractor's services as a "physician in the group practice."

4. Recruited physicians. A group practice that accepts economic assistance for the recruitment of a physician must abide by (a) certain new accounting rules that are tightened and (b) certain restrictions which have been loosened as to noncompetition items.

5. Academic medical centers. The Stark III regulations make some clarifications to the academic medical center exception. The academic medical center exception as a whole provides greater latitude as to specific compensation payments as long as the aggregate compensation paid is at fair market value.

   Some of the Stark III clarifications include (a) the requirement to aggregate physician faculty member compensation relationships in order to determine fair market value and (b) the method for counting faculty member physicians.

6. Productivity bonuses. The Stark III regulations permit payment of a productivity bonus to a physician for income directly derived from DHS referrals that are "incident to" the physician's performance of services.

   This expansion is of limited practical effect because (a) this benefit is limited to productivity bonuses but not profit sharing and (b) referrals truly "incident to" the physician's referrals are generally few.

7. Fair market value. The fair market value exception is expanded to include arrangements whereby a physician makes payments to an entity providing DHS (such as a payment for health services), and not just to situations where an entity makes payments to a physician (such as a medical director agreement).

8. Amendments. The Stark III regulations clarify that amendments to agreements implicated by the Stark laws are acceptable so long as the economic elements of the agreement (such as the rate of physician compensation or the square footage of a lease) remain materially unchanged by the amendment.

9. Holdovers. The Stark III regulations specifically allow for month-to-month holdover payments after the expiration of a rental agreement or a personal services arrangement (such as an agreement with a pathologist or radiologist) (a) for up to six months and (b) as long as the terms and conditions of the expired agreement do not change during the holdover period.

10. Other issues. The Stark III regulations provide additional clarifications and minor revisions that provide some practical guidance regarding nonmonetary compensation, compliance training, and professional courtesy.

The Phase II Stark laws created a "safe harbor" in the definition of fair market value for hourly payments to physicians for their personal services. Although acknowledging that several methods of estimating fair market value exist, the CMS would automatically consider the following compensation valuation methods to result in fair market value:

1. An hourly payment less than or equal to the average hourly rate for emergency room physician services in the relevant physician market
2. The 50th percentile national compensation level based on one of several specified compensation data surveys

In response to health care industry comments, CMS announced two statements regarding the fair market value hourly rate compensation.

First, while a fair market value rate may be used to compensate a physician for both clinical and administrative work, CMS stated that there may be a distinction between the rate paid to a physician for administrative work as opposed to the rate paid to a physician for clinical work.

Second, CMS announced that a fair market value hourly rate could be used to determine an annual salary, provided that the hourly multiplier used to calculate such salary accurately reflected the number of hours a physician actually worked.

Prior to the issuance of the Stark III regulations, the fair market value exception protected arrangements whereby an entity providing DHS paid

compensation to a physician, family member of a physician, or group of physicians for the provisions of items or services if the arrangement met five specific requirements.

The Stark III regulations expand the fair market value exception to also include compensation made from a physician to an entity providing designated health services. Under the Stark III regulations, the fair market value exception covers payment made from the entity to a physician, as well as from the physician to a health care provider entity, provided that the following conditions are met:

1. The arrangement is set out in a writing signed by the parties describing the items or services.
2. The writing sets out a time frame for the arrangement.
3. The writing specifies the compensation, which must be set in advance, consistent with fair market value, and not determined in a manner that takes into account the volume or value of the physician's referrals.
4. The arrangement is commercially reasonable and furthers the legitimate business purpose of the parties.
5. The arrangement does not (a) violate the Anti-Kickback Statute or (b) involve the promotion of any business arrangement that violates state or federal law.

The Stark III regulations clarify that the fair market value exception does not apply to the leases of office space, but that such arrangements must fit the stricter lease of office space exception.

On August 19, 2008, CMS finalized the Stark IV regulations. The Stark IV regulations became effective on two different dates: some provisions became effective on October 1, 2008, and other provisions became effective on October 1, 2009.

Prior to the Stark IV regulations, CMS proposed to revise the Stark space and equipment lease exceptions to prohibit per use of per click charges under a lease with (1) the health care provider entity as the lessee and (2) the physician as the lessor.

In the Stark IV regulations, the space, equipment, fair market value, and indirect compensation exceptions prohibit rental charges that use a formula based on:

1. a percentage of the revenue attributable to the services performed or generated in the office space or with the equipment or
2. per-unit of service, to the extent the charges reflect services provided to a patient referred between the parties.

These Stark IV regulations revisions became effective on October 1, 2009.

In the Stark IV regulations, the "stand in the shoes" provisions were revised to clarify when a physician must, and when a physician may, "stand in the shoes" of his or her physician organization. Physicians who have an ownership or investment interest in a physician organization must be treated as standing in the shoes of that physician organization.

In contrast, a physician with a titular ownership interest is not required to stand in the shoes of his or her physician organization, although such a physician is permitted to do so.

The CMS defined a "titular" ownership or investment interest as an interest that does not include the ability or right to receive financial benefits or ownership or investment, including distribution or profits, dividends, proceeds of sale or similar returns on investment. The Stark IV regulations stand in the shoes revisions were effective on October 1, 2008.

Tax-Exempt Health Care Entity Transactions

Tax-exempt entities are exempt from federal income tax as organizations described in Section 501(c)(3) only if they are organized and operated exclusively for charitable purposes within the meaning of the statute. However, such tax-exempt entities are subject to certain restrictions with regard to acquisition, professional services, employee compensation, and other types of transactions.

The Service and many state attorneys general view tax-exempt entities as charitable trusts for the benefit of the public. The regulatory scheme of Section 501(c)(3) is designed to:

1. ensure the furtherance of public purposes and
2. prevent the diversion of charitable assets into private hands.

Private Inurement

The first type of restriction relates to private inurement. For Section 501(c)(3) tax-exempt entities, no part of the net earnings may inure to other benefit of any private shareholder or individual. This means that an individual can't receive the tax-exempt entity's funds, except as reasonable payment for goods or services. There is no minimum threshold related to the private inurement restriction, and there is no de minimis exception.

The private inurement restriction applies only to “private shareholders or individuals,” commonly referred to as “insiders” (i.e., those having a personal and private interest in or opportunity to influence the activities of the entity from the inside). It is noteworthy that the term “insider” does not appear in either the Internal Revenue Code or the Treasury Regulations. However, the term “insider” is widely used in the related legal, accounting, and valuation literature.

Private Benefit

The second type of restriction relates to private benefit. Section 501(c)(3) tax-exempt entities should be organized and operated to serve public rather than private interests. Unlike the private inurement transaction restrictions, the private benefit transaction restrictions are not absolute. To be a permissible transaction, a private benefit transaction should be incidental to (or a necessary concomitant of) accomplishment of the public benefits involved.

Private benefit should be balanced against the public benefit. And, the Service has issued regulations that provide examples of the test for serving a public rather than a private interest.

The private benefit prohibition is not limited to insiders. For example, some incidental private benefit is always present in hospital-physician relationships (e.g., when a private practice physician uses a tax-exempt hospital facilities to treat his or her paying patients).

Any private inurement or too much (i.e., other than incidental) private benefit could cause a tax-exempt hospital to lose its tax exemption. Until 1995, the revocation of the organization’s tax exemption was the only sanction available to the Service.

However, with regard to both private inurement and excess private benefit, the Service currently relies principally on the imposition of Section 4958 intermediate sanctions excise tax penalties.

Excess Benefit

Section 4958 allows the Service to impose penalty excise taxes on certain (excess benefits transactions between “disqualified persons” and Sections 501(c)(3) or 501(c)(4) tax-exempt entities.

Excess benefit transactions include the following:

1. A transaction priced at other than fair market value in which a disqualified person (a) pays less than fair market value to the tax-exempt entity or (b) charges the tax-exempt entity more than fair market value for a property or service
2. An unreasonable compensation transaction, in which a disqualified person receives greater than a fair market value level of compensation
3. A prohibited revenue-sharing transaction, in which a disqualified person receives payment based on the revenue of the tax-exempt entity in an arrangement specified in the Section 4958 regulations that violates the inurement prohibition under current law.

Disqualified Persons

Section 4958 defines certain individuals to be “disqualified persons,” including:

1. voting members of the entity’s governing board;
2. individuals who have or share ultimate responsibility for implementing the decisions of the governing body or for supervising management, administration, or operation of the entity (such as president, chief executive officer, chief operating officer, treasurer, and chief financial officer unless demonstrated otherwise); and
3. individuals with a material financial interest in a provider-sponsored organization.

The Section 4958 regulations clarify that this category of disqualified persons can include entities such as management companies.

The Section 4958 regulations indicate that a “disqualified person” is:

1. any individual who was, at any time during the previous five years, in a position to exercise substantial influence over the affairs of the entity;
2. certain family members (lineal descendants, brothers and sisters, whether by whole or half-blood, and spouses of any of them); or
3. an entity 35 percent or more of which is controlled by such individuals.

The Initial Contract Rule

The Section 4958 regulations establish an “initial contract rule” to protect from intermediate sanctions liability certain “fixed” payments for the provision of services or the sale of property made under a binding written contract. The initial contract only applies to persons who were not disqualified persons immediately before entering into the initial contract.

Fixed payments are defined to include an amount of cash or other property that is either:

1. specified in the contract or
2. determined using a fixed formula specified in the initial contract.

Also, payments that include a variable component (such as achieving certain levels of revenue or business activity) may qualify as a fixed payment—as long as the components are calculated pursuant to a pre-established, objective formula.

Section 4958 Penalty Excise Taxes

Under Section 4958, a disqualified person is liable for (1) an initial 25 percent penalty excise tax on the amount of the excess benefit and (2) an additional penalty tax of 200 percent on the amount of the excess benefit if the transaction is not timely corrected. A tax-exempt entity manager who knowingly, willfully, and without reasonable cause participates in an excess benefit transaction is personally liable for a 10 percent penalty tax (up to a maximum of $20,000) on the amount of the excess benefit.

Intermediate Sanctions

The purpose of intermediate sanctions is to prevent wrongdoing by persons who have a special relationship with tax-exempt entities, particularly charitable entities.

Before the intermediate sanctions laws, when faced with one of these inappropriate transactions, the Service had two choices:

1. Apply the private inurement doctrine or the private benefit doctrine and revoke the tax-exempt status of the subject entity
2. Ignore the matter (and perhaps informally attempt to influence the behavior of the parties involved on a going-forward basis)

Revocation of an entity's tax-exempt status is a harsh consequence. The loss of the subject entity's tax-exempt status does not necessarily resolve the underlying problem—the party that obtained the inappropriate benefit still has it. The only individuals truly punished in these situations are the beneficiaries of the tax-exempt entity's programs.

Intermediate sanctions are penalties imposed on the person or persons who engage in the inappropriate transaction with the tax-exempt entity. These sanctions are called "intermediate" because they fall between (1) the revocation of the tax-exempt status and (2) inaction on the part of the Service.

The sanctions are not applied to the tax-exempt entity that was abused. Rather, the sanctions are imposed on the person or persons who improperly benefited from the property or services transfer.

The intermediate sanctions law does not replace either (1) the private inurement doctrine or (2) the private benefit doctrine. Rather, the Service has a range of taxpayer penalty options. The Service can:

1. impose the sanctions alone,
2. impose both the sanctions and the private inurement doctrine, or
3. find the sanctions do not apply and nonetheless invoke the private benefit doctrine.

Intermediate Sanction Taxes

The intermediate sanctions are, in fact, federal excise taxes. These federal excise taxes are applied to the amount involved in the impermissible transaction—that is, the excess benefit. The person who pays for intermediate sanctions tax (again, not the tax-exempt entity itself) is referred to as a disqualified person.

The first intermediate sanctions tax is an "initial tax." The initial tax is 25 percent of the amount of the excess benefit. Also, the excess benefit property or services transaction must be reversed. This reversal or refund of the excess benefit transaction is intended to put the parties in the same economic position they were in before the excess benefit transaction was entered into. This process is referred to as the correction of the transaction.

If (1) the initial tax is not timely paid and (2) the offending transaction is not timely and properly corrected, then an "additional tax" may be imposed. This intermediate sanctions tax is 200 percent of the amount of the excess benefit. In some instances, the trustees, directors, or officers with the tax-exempt entity may also be required to pay a tax of 10 percent of the amount of the excess benefit.

Under certain circumstances, the intermediate sanctions tax may be abated. The intermediate sanctions excise taxes are generally referred to as "penalties."

Excess Benefit Transaction Presumption of Reasonableness

There is an important "presumption of reasonableness" that every tax-exempt health care entity may endeavor to take advantage of. That presumption is

in favor of the tax-exempt health care entity that a compensation arrangement or property sale or rental is not an excess benefit.

To qualify for this presumption of reasonableness, the entity must meet the following three requirements:

1. The compensation arrangement or property sale or rental must be approved by the entity's governing body or a committee of the governing body composed entirely of individuals who do not have a conflict of interest with respect to the subject transaction.
2. The governing body or its committee must have obtained and relied on "appropriate data" as to comparability prior to making its decision.
3. The governing body or its committee must have "adequately documented" the basis for its decision at the time that it was made.

These three presumptions of reasonableness requirements are further described below.

Conflict of Interest

A member of a tax-exempt health care entity governing body or its committee will be treated as not having a conflict of interest if he or she:

1. is not
    a. the disqualified person benefiting from the subject transaction or
    b. a person related to the disqualified person;
2. is not an employee subject to the control or direction of the disqualified person;
3. does not receive compensation or other payments subject to approval of the disqualified person;
4. has no financial interest affected by the subject transactions; and
5. will not receive any economic benefit from another transaction in which the disqualified person must grant approval.

Appropriate Data

The category of "appropriate data" includes such information and documents as:

1. the compensation levels actually paid by similarly situated entities, both for-profit and tax-exempt, for similar positions;
2. independent compensation surveys compiled by independent consulting firms;
3. actual written offers from similar entities competing for the services of the disqualified person; and
4. independent valuations of the fair market value of the to-be-transferred property.

There is a special "appropriate data" relief provision for a tax-exempt health care entity with annual gross receipts of less than $1 million. Such a tax-exempt entity will be automatically treated as satisfying the appropriate data requirement if it has data on the level of compensation actually paid for similar services by five comparable entities in similar communities.

Adequate Documentation

To meet the "adequate documentation" requirement, the tax-exempt health care entity governing body or its committee must have written or electronic records showing:

1. the terms of the transaction and the date it was approved,
2. the members of the governing body or committee who were present during debate on the transaction and the names of those who voted on it,
3. the comparability data obtained, and
4. what actions were taken about the members who had a conflict of interest.

For a decision to be documented concurrently, the records must be prepared by the next meeting of the governing body or committee occurring after the final action is taken. Also, the records must be reviewed and approved by the governing body or committee as reasonable, accurate, and complete within a reasonable time period thereafter.

For this presumption of reasonableness exclusion, a tax-exempt entity governing body is (1) a board of directors, (2) a board of trustees, or (3) an equivalent controlling body of the entity.

A committee of the entity governing body (1) may be composed of any individuals permitted under state law to serve on such a committee and (2) may act on behalf of the governing body to the extent permitted by state law.

The tax-exempt entity should note that if a committee member is not on the governing board and the presumption of reasonableness is relied on, then the committee member becomes an "organization manager" for purposes of the 10 percent excise tax penalty. In other words, the committee member is treated like a member of the governing body if the

presumption of reasonableness relied upon is rebutted by the Service.

A person will not be treated as a member of the entity's governing body or its committee if he or she (1) meets with other members only to answer questions and (2) is not present during debate and voting on the transaction.

A health care entity subject to the intermediate sanctions law should note that this presumption of reasonableness is only a presumption. The Service can rebut the presumption of reasonableness if there is information indicating that:

1. the amount of the compensation was not reasonable or
2. the property transfer was not at a fair market value price.

These three requirements often help a tax-exempt health care entity avoid the Section 4958 intermediate sanctions penalties.

Analyst Considerations Regarding Private Inurement

This section presents a list of analyst considerations with regard to valuations performed for tax-exempt health care entities. These valuations include fair market value valuations of:

1. property and
2. services.

These considerations may not affect the specific valuation approaches, methods, and procedures that the analyst selects and performs. And, these considerations may not affect the analyst's conclusions regarding the fair market value of the property or services transfers.

However, these considerations relate to the intermediate sanctions law and regulations that the analyst should be aware of during the performance of the health care entity valuation.

Tax-Exempt Health Care Entities

The Internal Revenue Code grants a tax exemption for not-for-profit hospitals and other health care entities provided that their net earnings do not inure to:

1. the benefit of private shareholders or
2. individuals with a "personal and private" interest in the health care entity's activities.

Criteria to Be Recognized as a Tax-Exempt Entity

To be recognized as a tax-exempt entity, the health care entity must comply with the following rules:

- Physicians cannot be "in a position to exercise substantial influence over the affairs of (the hospital).
- The total compensation must be "reasonable" and the incentive arrangement may not be a disguised distribution of profits.
- The compensation arrangements must be negotiated or established in the context of an arm's-length relationship.
- There is a ceiling or reasonable maximum compensation level.

No Inurement

No portion of the entity's income or assets may inure to the benefit of "insiders." The term "insiders" may be defined as someone with decision power (e.g., board members, officers, founders, selected physicians, and so on).

Examples of such private inurement may include:

- excessive employee or subcontractor compensation,
- compensation based on the "net earnings" of the tax-exemption entity, and
- any transfer of property or services at less than a fair market value price.

Penalty for Private Inurement

There are penalties for any violation of this no-inurement rule. The Service may apply a broad spectrum of remedies, including:

- revocation of the health care entity's tax-exempt status,
- settlement of the amount of the inurement, and
- the Section 4958 intermediate sanctions excise taxes.

Purpose of Intermediate Sanctions

The purpose of the Section 4958 is to curb potential abuses by penalizing participating parties (both those that benefit from the abuse and those that knowingly authorize it). The intermediate sanctions law applies if there is an "excess benefit" transaction with a "disqualified person."

An excess benefit transaction occurs when the economic benefit given in a transaction is greater than the consideration received by the health care

tax-exempt entity. A disqualified person is any person having the ability to exercise influence over the tax-exempt entity affairs.

Imposition of Penalty Excise Taxes

Section 4958 imposes excise tax penalties on:

1. the disqualified person who has to correct the excess amount (i.e., pay it back to the tax-exempt health care entity) plus pay a penalty tax of 25 percent and
2. the entity manager who has to pay a tax equal to 10 percent of the excess benefit amount (not to exceed $20,000 per transaction).

Rebuttal Presumption of Reasonableness

There is a rebuttable presumption of a reasonableness with regard to the health care entity entering into a property or services transfer when:

1. the transfer is approved in advance by an independent, authorized body of the tax-exempt entity,
2. the decision was based on the appropriate comparability data, and
3. the decision is adequately and timely documented (i.e., written down by the later of the next meeting or 60 days).

Excess Benefit Transaction

An excess benefit transaction is any transaction in which an economic benefit is provided by the tax-exempt health care entity directly or indirectly to or for the use of any "disqualified person" if the fair market value of the benefit exceeds the fair market value of the consideration.

Disqualified Persons

For purposes of Section 4958, a "disqualified person" includes:

1. a voting member of a board of the tax-exempt health care entity;
2. the chief executive officer, chief operating officer, treasurer, or chief financial officer;
3. any person, at any time during the previous five years, in a position to exercise substantial influence over the affairs of the health care entity;
4. identified family members of the above; and
5. a 35 percent controlled entity.

Not a Disqualified Person

For purposes of Section 4958, the following "persons" are not disqualified persons:

1. Entities described in Section 591(c)(3); this exception was created by the Pension Protection Act of 2006
2. Other Section 501(c)(4) entities (applicable for Section 501(c)(4) entities only)
3. Employees receiving less than $100,000 a year in compensation

"To alleviate concerns regarding intermediate sanctions, the entity should establish that its executive and physician employees are not paid more than a fair market value level of compensation."

Reasonableness of Tax-Exempt Entity Compensation

One controversy related to intermediate sanctions requirements relates to the reasonableness of employee or contractor compensation. This compensation issue appears to be the current focus of Service scrutiny with regard to tax-exempt entities.

To alleviate concerns regarding intermediate sanctions, the entity should establish that its executive and physician employees are not paid more than a fair market value level of compensation.

Related to reasonableness of compensation, many health care entities benefit from reliance on a dedicated compensation committee. Such a board-level compensation committee would:

1. adopt a written charter,
2. be comprised of independent directors, and
3. be authorized to approve the health care entity's executive compensation.

Such a board-level compensation committee would also likely adopt a written compensation policy.

When considering the reasonableness of tax-exempt health care entity compensation, the Service looks at how the entity determined and documented the comparability of its executive compensation to other similarly situation entities.

The analyst can assist the tax-exempt health care entity with the following:

1. Compensation levels paid by similarly situated health care entities, both taxable and tax-exempt
2. Independent compensation surveys compiled by independent consulting firms
3. Actual written offers from similar health care entities
4. Independent valuations of the fair market value of the subject executive compensation

The analyst can assemble compensation data and prepare a fair market value compensation valuation that considers the following:

1. Make sure that any analyst relied on is independent and has no incentive to support higher pay and benefits.
2. Use data for the same or the closest functional position, and support these data in the board minutes.
3. Use data for entities with a similar level of annual revenue, or demonstrate that the compensation data was "normalized" to fit entities of a similar size.

In the preparation of a compensation valuation, the analyst may consider the following caveats:

1. The use of for-profit entity compensation data are permitted, but the analyst should avoid relying exclusively on for-profit entity compensation data
2. Include compensation data related to the value of any significant or unusual employee benefits
3. Make sure that every element is considered and the total compensation is assessed for reasonableness (and approved by an authorized body of the tax-exempt health care entity)

The approving body of the entity is protected in its reliance on the analyst's written reasoned analysis, if the analyst certified that he or she:

1. holds himself or herself out to the public as a compensation consultant,
2. performs this type of compensation valuation regularly, and
3. is qualified to perform such a compensation valuation.

Such a written certification should be included in every compensation valuation.

Revocation of the Tax-Exempt Status

The Service may still revoke the entity's tax-exempt status. With regard to health care and other tax-exempt entities, the analyst should be aware that the Service may seek revocation—in addition to the provision of the intermediate sanctions excise taxes.

The Service has announced that it will consider a list of facts and circumstances in determining when the level of excess benefit transactions will jeopardize a health care entity's tax exemption.

These factors include the following:

1. The size and scope of the health care entity's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred
2. The size and scope of the excess benefit transaction or transactions (collectively, if there are more than one) in relation to the size and scope of the health care entity's regular and ongoing activities that further exempt purposes
3. Whether the health care entity has been involved in repeated excess benefit transactions
4. Whether the health care entity has implemented safeguards that are reasonably calculated to prevent future violations
5. Whether the excess benefit transaction has been corrected or the health care entity has made good-faith efforts to seek correction from the disqualified persons who benefited from it

Analyst Misconceptions Regarding Health Care Property and Services Valuations

This section describes and responds to 10 analyst common misconceptions with regard to valuations of health care entity property and/or services transfers. These analyst misconceptions are considered in this discussion because they are generally due to a misunderstanding of one or more of the relevant regulatory provisions.

That is, these analyst misconceptions typically relate to an erroneous understanding that "the Service only accepts this" or "the OIG doesn't accept that." Therefore, these analyst common misconceptions are addressed from the perspective of the regulatory compliance of the valuation analysis.

There Is a Preferred Valuation Approach or Method

Some analysts believe that certain health care transaction audit or regulatory authorities have a preferred valuation approach or method. None of the health care transfer statutes or regulations mandate a property or services valuation preferred approach.

Any of the generally accepted property or services valuation approaches and methods may be used in a health care entity transfer analysis—as long as the analysis conclusion is fair market value.

There Is a Prohibited Valuation Approach or Method

Some analysts erroneously believe that there is a prohibition against using certain valuation approaches and methods. For example, some analysts believe that the income approach, and particularly the discounted cash flow method, is inappropriate to health care property or services valuations. The basis for this erroneous belief is that such a methodology has to include the income from prohibited patient referrals.

No health care entity can pay a transaction price that includes patient referrals. However, that statement does not invalidate the use of the income approach. The analyst simply has to be careful to exclude any income from post-transaction prohibited patient referrals in the income approach analysis.

Some analysts believe that an adjusted net asset value method is inappropriate if it incorporates some type of a capitalized excess earnings procedure. The basis for this erroneous belief is that no health care entity is allowed to earn excess earnings. In fact, there is no prohibition on using this valuation method.

There is no prohibition on any particular health care entity earning a high profit margin (as long as there is no fraud and abuse contributing to that income, of course).

Let's assume that, for purposes of the subject valuation, excess earnings are defined as excess above the median profit margin level for that health care industry segment. Based on that excess earnings definition, half of all of the entities in the industry segment may earn excess earnings (i.e., half of the health care entities will earn income above the median level, and half of the health care entities will earn income below the median level).

All Health Care Valuations Should Be Performed on a Before-Tax Basis

In order to adjust for the fact that some health care industry acquirers are tax-exempt and some health care industry acquirers are for-profit entities, some analysts ignore income taxes altogether—and perform all valuations on a pretax basis.

Some analysts erroneously believe that this procedure prevents the tax-exempt entity from paying more than fair market value for a target health care entity. This objective is certainly appropriate. However, there is no regulatory requirement that all health care property (or services) valuations be performed on a pretax basis—or on an after-tax basis, for that matter.

Typically, if the property (or services) valuation variables are derived in a consistent basis, then the subject health care property (or services) should have one fair market value—whether the variables are measured on a pretax basis or an after-tax basis. That is, the valuation can be performed with all valuation variables (discount rates, capitalization rates, pricing multiples, income metrics) derived on a pretax basis.

Alternatively, the valuation can be performed with all valuation variables derived on an after-tax basis. The fair market value conclusion should be about the same.

There is no regulatory (or theoretical) preference—or prohibition—for performing health care property (or services) valuations on a pretax basis compared to an after-tax basis.

There Should Be No Goodwill Included in the Health Care Valuation

Some analysts erroneously believe that audit and regulatory authorities do not allow the inclusion of either an individual practitioner's goodwill or an

entity's institutional goodwill in a health care property transfer valuation. These analysts may conclude that any goodwill value includes the value of prohibited patient referrals or the value of excess (and suspicious) earnings.

There is no legislative or regulatory prohibition on the health care entity (tax-exempt or otherwise) paying for the goodwill of a target health care entity. There is no prohibition on including the value of goodwill in the health care property valuation.

Goodwill can be measured many different ways. But, goodwill is basically the value of the health care entity's ongoing business operations in excess of the value of the entity's tangible assets. For a successful going-concern business operation, the analyst would expect the health care entity to have some amount of goodwill.

The goodwill value should not include future prohibited transactions or expected post-acquisition synergies or economies of scale. But, if the target entity's historical results of operations indicate a positive goodwill value, then that goodwill value should be included in the health care property transfer valuation.

Typically, the goodwill value is included in the asset-based approach valuation analysis of the target entity value. And, that goodwill value may be measured in either the asset accumulation method or the adjusted net asset value method of the asset-based approach to business enterprise valuation.

There Should Be No Patient Relationships Value Included in the Health Care Valuation

Often the analysts who exclude goodwill value will also exclude the value of any patient relationships-related intangible asset from the health care valuation. This procedure (or lack of performing a procedure) is particularly important when the analyst uses the asset-based business valuation approach (and, specifically, the asset accumulation method) to value the health care property transfer.

First, the statutory and regulatory prohibition relates to any health care provider (tax-exempt or otherwise) paying for patient referrals to the acquirer entity. Second, there is no prohibition of a health care acquirer paying for the current patient relationships (not the patient referrals to the acquirer) of the target health care entity.

In virtually any industry or profession, a good part of the value of a target business relates to the income earned from the entity's current customer (in this case, patient) relationships. The value of these current patient relationships is often measured based on the expected future income from the current patients returning to the current health care services provider. Such a value does not (and should not) include the expected future income from the future referrals of current patients to the acquirer health care entity.

No Health Care Entity Can Pay Reasonable Compensation over $1 Million per Individual

Some analysts erroneously believe that there is an arbitrary dollar amount (say, $1 million per year) of reasonable compensation above which health care regulatory authorities will not accept. These analysts may also erroneously believe that there are arbitrary "ceilings" on fair market value compensation for different professional positions—for example, a chief executive officer, chief medical officer, chief research officer, operating room director, emergency room director, and the like.

There are no such arbitrary limits on the fair market value level of compensation—either in the relevant statutes or in the relevant regulations.

There are numerous factors that an analyst should consider in assessing the fair market value of a health care entity executive or professional compensation. Likewise, there are numerous factors that an analyst should consider in assessing the fair market value compensation-related contract terms for health care entity contractors.

All of these factors are consistent with the overarching consideration with regard to the fair market value of either employee or contractor compensation: the compensation should be commensurate with the compensation levels paid to similarly qualified individuals performing similar functions at similar organizations.

The Analyst Should Not Use For-Profit Organizations as Comparables in a Compensation Analysis

Some analysts erroneously believe that for-profit business entities do not provide meaningful guidance with regard to the fair market value compensation assessment of a tax-exempt entity employee or contractor. As mentioned above, the general regulatory guidance with regard to fair market value compensation is that the analyst should consider comparable individuals in comparable situations at comparable organizations.

First, with respect to providing empirical evidence regarding market-derived compensation levels, tax-exempt health care entities and for-profit

health care entities are comparable in at least one important respect. Both types of health care entities are subject to the Medicare fraud and abuse statutes and regulations. Therefore, ignoring income tax status considerations, neither type of health care entity may seek reimbursement for employee or contractor compensation expense in excess of fair market value compensation levels.

Second, health care entities and many related industry entities are comparable in at least one other important respect. That is, they all compete for the same pool of executive and professional talent. Health care providers, insurance companies, pharmaceutical companies, research institutes, universities, and other organizations all are competing to recruit the same pool of executive, technical, and professional talent. In addition, when a health care entity employee or contractor decides to change jobs, he or she can interview with all of these related-industry entities.

Employers will recruit—and compensate—the most talented employees (even if that means recruiting an employee from a related industry). Likewise, the employees will interview with—and work for—the highest-paying employers (even if that means working for an employer in a related industry).

In a fair market value compensation analysis, the analyst should consider the "big picture" with regard to compensation paid by competing employers and compensation received by competing employees. With regard to the supply and demand for executive, technical, and professional talent, comparable organizations can be (1) either for-profit or not-for-profit and (2) in related industries.

A Services Supplier Cannot Earn Excess Profits on a Fair Market Value Services Contract

Like the fair market value of employee and contractor compensation, the general rule with regard to the fair market value of supplier contract price is that it should be supported by empirical market data. That is, the subject health care entity contract price should be comparable to prices paid by comparable entities for comparable contract services.

Like employees offering employment services, service providers are free to offer their services to both for-profit entities and tax-exempt entities. Likewise, service providers are free to offer their services to entities in related industries. Accordingly, for-profit entities and related industry entities may provide a source of empirical data for assessing the fair market value of market-derived contract services prices.

Further, there is no statutory or regulatory prohibition that an efficient services provider cannot earn a profit margin (even a high profit margin) providing services to a health care entity. Rather, the services providers must charge fair market value prices for the services they provide to the health care entity. Excess earnings methods and profit split methods may have certain applications in health care property valuation circumstances.

However, neither of these methods is used to measure the fair market value price for professional, administrative, technical, or other contract services provided to a health care entity.

Analysts Should Only Consider Data from For-Profit Acquirers in Health Care Property Valuations

Some analysts erroneously believe that they should only consider valuation variables extracted from empirical data with regard to for-profit buyer transactions. Such valuation variables may include discount rates, capitalization rates, pricing multiples, and so forth.

These analysts erroneously believe that this procedure will prevent the subject health care entity (particularly a tax-exempt entity) from paying more than fair market value for property or services. Presumably, this belief is based on the erroneous premise that tax-exempt buyer transactions (related to property or services) include some amount of price premium associated with the buyer's tax-exempt status.

In other words, this belief is based on the misconception that tax-exempt entities generally pay more than a fair market value price for purchased property or services.

It is possible that any buyer (health care or otherwise, tax-exempt or otherwise) could occasionally pay more than fair market value for property or services. Likewise, it is possible that any buyer could occasionally pay less than fair market value for property or services.

However, there is no empirical evidence to indicate that any class of buyer (and particularly health care buyers or tax-exempt buyers) consistently pays more than (or less than) fair market value for property or services. Therefore, there is no empirical or theoretical reason to exclude a tax-exempt health care property or services transfer from the analyst's data gathering or valuation analysis.

Paying a Fair Market Value Price Is the Same as Having a Commercially Reasonable Purpose

To comply with the relevant federal statutes and regulations, health care entities (and their legal counsel) often ask the analyst to opine that a pending transfer is both:

1. priced at fair market value and
2. commercially reasonable.

Some analysts erroneously believe that proving one of these propositions (i.e., that the transfer is priced at fair market value) also provides the second of these propositions (i.e., that the property or services transfer is commercially reasonable and has a valid business purpose). That analyst belief is incorrect.

A property or services transfer could be priced at fair market value—and still there is no valid business purpose for the proposed transfer. In other words, that transfer would not be commercially reasonable. Likewise, there could be a perfectly valid business purpose for the health care entity to enter into the property or services transfer—yet the transfer could be priced at above fair market value.

In other words, that transfer could still be commercially reasonable (even though it was not priced at a fair market value price).

Each of these two opinions (i.e., fair market value price and commercially reasonable purpose) deserves its own individual consideration and analysis. Each of these two transfer transaction opinions can be reached by the analyst independently of the other opinion.

Analyst Misconceptions Summary

This section considered 10 common misconceptions with regard to health care transfer fair market value analyses. Each of these analyst beliefs is considered a misconception when it is compared to the professional guidance provided by the relevant statutory authority and regulations.

There are, of course, valid analyst beliefs with regard to health care fair market value valuations.

First, in the valuation of any health care property transfer, the analyst should understand the transfer transaction. For example, the analyst should understand if a pending transaction will be the purchase of the entity assets or of the entity equity.

Second, in the property transfer valuation, the analyst should consider both the payment price and the payment terms. For example, the analyst should investigate if there is any seller financing. And, the analyst should investigate whether the property purchase price will be paid in cash at the closing—or whether there will be a series of payments over a time period. If there are payment terms, then the analyst should assess whether those terms are at fair market value.

Third, the analyst should consider if there are several contracts being entered into as part of the property transfer. For example, the analyst should consider whether there are earn-out provisions to the property transfer transaction. And, the analyst should consider whether there are employment agreements, noncompete agreements, intellectual property licensees, lease transfers, or other agreements that are part of the overall transaction. If so, the analyst should assess the fair market value of the total (multi-contract) transaction.

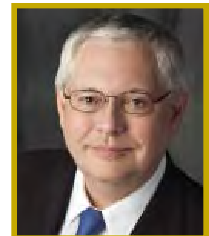
Fourth, the analyst should consider whether the transaction includes both a property transfer and a services transfer. And, the analyst should consider the direction (i.e., from whom to whom) of both the property transfer component and the services transfer component. Both components of the transfer have to be at fair market value if the total transaction is considered to be a fair market value transaction.

Finally, this section considered both analyst misconceptions and analyst correct perceptions with regard to the fair market value analysis of a entity property transfer or services transfer.

Summary and Conclusion

This discussion focused on the role of fair market value valuations with regard to a health care entity property and services transfers. In particular, this discussion considered the regulatory implications of a health care property or services transfer when one participant is a tax-exempt entity.

Analysts who performs valuations of health care property or services transfers should be aware of the various regulatory requirements with regard to such fair market value valuations. Analysts should be familiar with the regulatory environment with regard to private inurement, excess benefit transactions, intermediate sanctions excise tax penalties, and other regulatory issues.



Robert Reilly is a managing director of the firm and is resident in our Chicago practice office. Robert can be reached at (773) 399-4318 or at rfreilly@willamette.com.

On Our Web Site

Recent Articles and Presentations

Robert Reilly, a managing director of our firm, co-delivered a two-part presentation at the 45th Annual Appraisal for Ad Valorem Taxation of Communications, Energy and Transportation Properties Conference, which was held June 26-30, 2015, in Wichita. Robert's co-presenter was Marshall Mungle. The title of their presentation was "Identification, Valuation and Extraction of Exempt Intangible Personal Property."

In Part 1, Robert and Marshall discussed the identification of intangible assets, reasons to value intangible assets, intangible asset property tax considerations, generally accepted approaches for valuing intangible assets. They also provided illustrative examples of the three generally accepted approaches. In Part 2, they discussed reasons to extract intangible asset value, basic property appraisal accumulation and extraction procedures, common exempt property extraction procedures, and methods for intangible asset extraction from the total value. They also provided illustrative examples of the direct subtraction, income allocation, and royalty rate methods. Robert's presentation slides are available on our website.

Aaron Rotkowski, a manager in our Portland office and director of our property tax valuation services practice, also co-delivered a presentation at the 45th Annual Appraisal for Ad Valorem Taxation of Communications, Energy and Transportation Properties Conference in Wichita. Aaron's co-presenter was Michael Mangan. The title of their presentation was "Long-Term Growth Rate in the Income Approach."

Aaron and Michael gave an overview of the income approach and explained the importance of the long-term growth rate in this approach. They discussed real versus nominal growth rates, real estate growth rates, implications of selecting growth rates that exceed growth in the U.S. economy, internal consistency between the selected growth rate and the other variables in the income approach, and using market data and industry data to estimate the long-term growth rate. Aaron's presentation slides are available on our website.

Samuel S. Nicholls, a senior associate in our Atlanta office, authored an article that was published in the June 8, 2015, issue of *In-House Texas*, a monthly journal published by Texas Lawyer and ALM. The title of Sam's article is "Relief for Oppressed Minority Shareholders in Texas."

Sam's article explores a recent Texas Supreme Court decision, *Cardiac Perfusion Services v. Hughes*. In this matter, the absence of a shareholder oppression statute in Texas required the litigants to pursue a legal claim—the Texas receivership statute. Sam's article is available on our website.

Shawn Fox, a managing director in our Chicago office, participated in a webinar on the topic of "Best Practices in Dealing with Disputes and Litigation in a Limited Liability Company in 2015." Shawn's co-presenters were Aliette DelPozo Rodz and Margaret L. Watson. The webinar was held on June 22, 2015, and was sponsored by The Knowledge Group.

The webinar covered such topics as LLC operating agreements, alternative dispute resolution, tax requirements and regulations, and the importance of addressing deadlock scenarios and dissolution. Shawn's portion of the discussion explored calculating damages in member disputes involving breach of fiduciary duty, calculating damages for unjust enrichment and benefit of the bargain, and the pass-through entity valuation premium. Shawn's presentation slides are available on our website.

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Communiqué

In Print

Robert Reilly, firm managing director, authored an article that appeared in the Summer 2015 issue of the *American Journal of Family Law*. The title of Robert's article was "Goodwill Valuation Approaches, Methods, and Procedures."

Robert Reilly also authored an article that appeared in the July 2015 issue of the *ABI Journal*. The title of Robert's article was "Debtor Company Goodwill Valuation."

Robert Reilly also authored an article that appeared in the online publication *les Nouvelles* (at www.lesi.org). Robert's article was selected as the July 2015 article of the month for that publication, and the article is entitled "Technology Intangible Asset Valuation Procedures."

Robert Reilly also authored an article that appeared in the May/June 2015 issue of *Construction Accounting and Taxation*. The title of Robert's article was "Construction Company Goodwill Valuation Purposes, Concepts, Approaches, and Methods."

Robert Reilly also authored an article that appeared in the online newsletter *QuickRead*, published by the National Association of Certified Valuators and Analysts (NACVA). The title of the article was "Common Misconceptions Regarding Healthcare Entity Valuations." The date of Robert's article was August 6, 2015, and it can be found at www.nacva.com. Part 2 of this article appeared on August 13, 2015.

Robert Reilly also authored an article that appeared in the July 2014 issue of *Business Valuation Alert*. The title of Robert's article was "The IRS Continues to Pursue 'Economic-Substance' Challenges to Suspect Taxpayer Transactions."

Katherine Gilbert, Atlanta office manager, had an article reprinted in the June 2015 issue of the journal *Transaction Advisers*. The title of her article was "Transaction Structure Issues Regarding the Purchase/Sale of a Financially Distressed Company."

Samuel Nicholls, Atlanta office senior associate, authored an article in the June 8, 2015, issue of *In-House Texas*, a monthly publication for corporate counsel in the State of Texas. The title of Sam's article was "Relief for Oppressed Minority Shareholders in Texas."

Nathan Novak, Chicago office associate, authored an article in the July 2015 issue of the journal *Business Valuation Alert*. The title of Nate's article was "Using Regression Models to Predict DLOM: The Bajaj Study and Its Critics."

In Person

Robert Reilly will deliver a presentation at the American Bankruptcy Institute/UMKC Midwestern Bankruptcy Institute on October 15, 2015, in Kansas City. The topic of Robert's presentation is "Intellectual Property and Insolvency Issues."

Robert Reilly delivered two Master Analyst in Financial Forensics (MAFF) Workshop webinars on July 22 and 23, 2015. The July 22 webinar topic was "Valuation of Distressed Businesses." The July 23 webinar topic was "Solvency & Insolvency Testing and Plan of Reorganization."

Robert Reilly also delivered a presentation at the National Association of Certified Valuators and Analysts (NACVA) Business Valuation Conference in Pittsburgh, Pennsylvania, on September 15, 2015. The topic of Robert's presentation was "Valuation of Businesses, Securities, and Intangible Assets for Bankruptcy Purposes."

Robert Reilly also delivered a two-part presentation at the 45th Annual Wichita Program on Appraisal for Ad Valorem Taxation in Wichita, Kansas. The first topic of Robert's presentation was "Valuation of Exempt Intangible Personal Property—Illustrative Examples." The second topic of his presentation was "Extraction of Exempt Intangible Personal Property Value from the Total Unit Value."

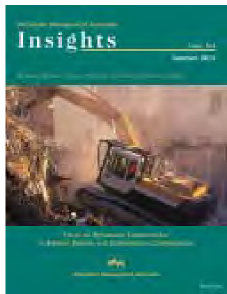
Robert Schweihs, firm managing director, also delivered a presentation at the 45th Annual Wichita Program. The topic of Bob's presentation was "Should Business Structure Affect Valuation?"

Aaron Rotkowski, Portland office manager, also delivered a presentation at the 45th Annual Wichita Program. The topic of Aaron's presentation was "Long-Term Growth in a DCF Valuation Analysis."

In Encomium

Kyle Wishing, Atlanta office associate, earned the chartered financial analyst (CFA) designation, granted by the CFA Institute.

Insights Archives



❑ Summer 2015

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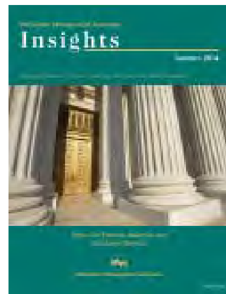

❑ Summer 2014

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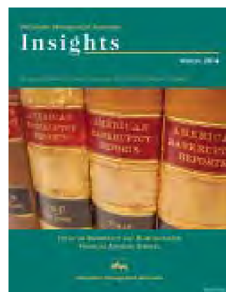

❑ Winter 2014

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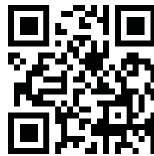

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Willamette Management Associates provides **thought leadership** in business valuation, forensic analysis, and financial opinion services. Our professional services include: business and intangible asset valuation, intellectual property valuation and royalty rate analysis, intercompany transfer price analysis, forensic analysis and expert testimony, transaction fairness opinions and solvency opinions, reasonableness of compensation analysis, lost profits and economic damages analysis, economic event analysis, M&A financial adviser and due diligence services, and ESOP financial adviser and adequate consideration opinions.

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