The Kentucky CPA Journal
Issue 6 2010
The Journal of the Kentucky Society of CPAs

Kentucky Society
Certified Public Accountants

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Fair value – with or without discounts

Are the rules changing in dissenter rights actions?

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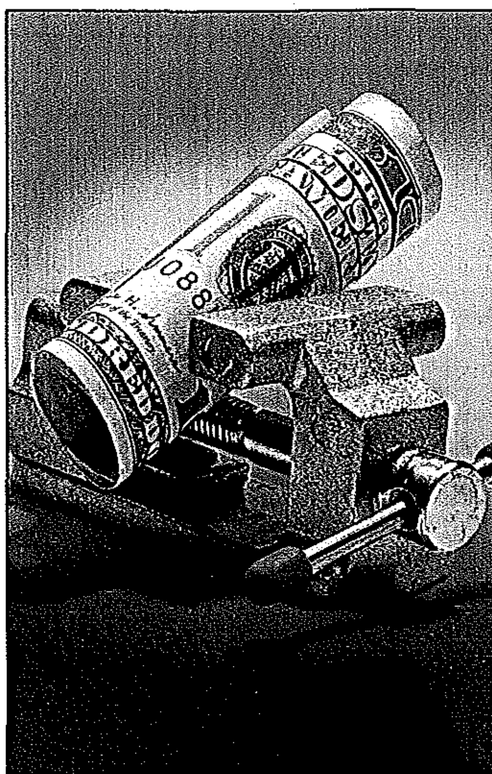
Minority shareholders in corporations (including Kentucky corporations) have the right to sell their stock to the company in the case of certain major transactions. The purpose of providing that right is to balance the needs of those in control to engage in a significant transaction with the needs of a minority shareholder to have reasonable protection.

Major transactions that trigger dissenter rights include mergers that require shareholder approval and certain dispositions of all or substantially all of a corporation's assets outside the ordinary course. For example, a technique known as a "squeeze-out merger" can be used to force a minority shareholder to take cash for shares while leaving the status of the other shareholders as owners of the corporation unchanged. The terms of the "squeeze-out merger" specify a price to be paid to the minority shareholder. If the minority shareholder does not think the price proposed by those in control is fair, the only meaningful alternative of the minority shareholder may be to exercise dissenter rights. If a minority shareholder takes all the steps necessary to preserve dissenter rights under the applicable statute, then that shareholder is entitled to be paid "fair value" for the shares following the completion of a subject transaction.



Fair value

The roles of accountants and attorneys often intersect in determining "fair value." For purposes of dissenter rights, in the case of a Kentucky corporation, KRS § 271B.13-010(3) contains the following definition:

"Fair value," with respect to a dissenter's shares, means 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.

This definition does not make it clear whether there should be minority, marketability or other discounts. While this issue has been addressed by Kentucky courts, we still lack clarity.

In a 1982 published decision, the Kentucky Court of Appeals accepted a valuation of minority shares in a corporation which applied a 25% discount to the stock on the basis of a marketability discount. *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553 (Ky. App. 1982). In accepting discounts for marketability, the Court of Appeals arguably morphed "fair value" into "market value," to the benefit of the remaining members. Hypothetically, assume the stock has a value of $100 assuming no discounts and a value of $75 if discounts are applied. By paying a dissenting shareholder only $75, the corporation avoids an expense of $25, retaining the benefit of those funds for the remaining shareholders. A shareholder exercising dissenter rights may feel that this is not fair and that he or she should not be subjected to discounts, particularly if the minority shareholder is being forced to sell as in the case of a squeeze-out merger. Still, under the *Ford* decision, the dissenting shareholders may find themselves receiving less than a pro-rata portion of the venture's value.

Since the ruling of the Court of Appeals in *Ford v. Courier Journal Job Printing Co.* the law has continued to develop. Kentucky's Business Corporation Act is based upon the Model Business Corporation Act, a product of the American Bar Association Committee on Corporate

Laws. In recent years that body has modified the model language to make express that, with respect to the determination of "fair value" to be employed in a dissenter rights action, discounts for marketability/minority position are not appropriate. Closer to home, Professor Rutheford "Biff" Campbell of the UK College of Law, a highly respected and widely cited authority on business organization law in the Commonwealth, has written against the rule adopted in *Ford* and advocated against minority discounts. In various decisions, including *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), the courts of Delaware (and it is to those courts that Kentucky courts and courts in other states often look for direction on matters of business organization law) have rejected minority discounts in dissenter rights valuations. Still, as of this date, the statute in Kentucky has not been modified to dictate a result different than that arguably determined appropriate in the *Ford* case.

However, the ability of minority shareholders to argue against discounts may be improving. A recent unpublished decision of the Kentucky Court of Appeals, *Shawnee Telecom Resources, Inc. v. Brown*, rendered in the context of a squeeze-out merger, refused to accept a marketability discount. While the company argued strongly that a 25% discount for lack of marketability of Brown's stock was appropriate, the Court of Appeals, adopting the reasoning employed by the Delaware Chancery Court, determined to the contrary. As such, under the reasoning of *Shawnee v. Brown*, the shareholders remaining in the corporation do not harvest to their own benefit the differential of the minority discount; rather, the corporation must pay the dissenting shareholder the pro-rata portion of its value. The Kentucky Supreme Court will hear the appeal brought by *Shawnee Telecom* seeking to have the ruling of the Court of Appeals reversed.

So where do matters stand today?

On the one hand, under an admittedly dated, but published, opinion of the Kentucky Court of Appeals, in the context of a dissenter rights action, it may be appropriate to apply minority/marketability discounts. Conversely, under a much more recent but unpublished ruling of the Court of Appeals and one which incorporates the latest thinking of the Delaware Chancery Courts, it has been held that, in the context of a particular dissenter rights action, it was not appropriate to apply minority discount factors. While at first blush it appears these rulings are in conflict with one another, the *Shawnee Telecom* court did not overrule *Ford v. Courier Journal*. The *Shawnee Telecom* court determined that discounts should not be applied in the context of the particular dissenter rights action brought with respect to a closely held company, distinguishing the situation where stock is bought and sold on the open market.

So, what is the appraiser to do?

Typically, when retained to provide a valuation of shares in connection with a dissenter rights action, the appraiser should request direction from legal counsel as to whether, in the context of the particular business organization, the appraiser should provide (1) a valuation on the basis of "fair market value" of the particular shares, *i.e.*, one that employs marketability/minority discounts, or (2) a valuation on the basis of the "fair market value" of the corporation divided by the number of outstanding shares times the number of shares being sold, *i.e.*, one that does not employ those discounts. Of course, a valuation report can always recite conclusions under both forms of analysis. Those directions from legal counsel may also address other issues impacting valuation such as, for example, share restriction agreements that may, by private ordering, either dictate valuation methodologies or the application of particular discounts.

In the meantime, careful attention should be given to the status of the *Shawnee Telecom* case (and any further decisions that address it) and potential action on this point by the Kentucky General Assembly.

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