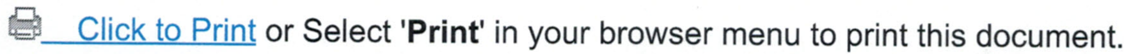
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Mediating Valuation Disputes in Minority Oppression Litigation

Arthur H. Rosenbloom, New York Law Journal

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When minority shareholders of an entity sue the entity or the controlling shareholders in it claiming that the conduct of those in control has been oppressive, you can bet your bottom dollar that, after all the fireworks go off, resolution of the matter may well turn on how much it will take to buy the minority out. This piece explains the theory and practice of oppression litigation under Section 1104-a and 1118 of the New York Business Corporation Law (BCL) and how, if such matters are mediated, the mediator's role in getting the matter to settle.

Theory and Practice

Oppression cases are brought under state statutes or common law theories. They all assert that acts undertaken or not undertaken by the majority have so oppressed the minority shareholders, that in the case of statutory claims, the company should be dissolved or in common law settings, that there has been a breach of fiduciary duty to minority shareholders.[1]

Section 1104-a provides that minority shareholders of a closely held corporation owning 20 percent or more of that company's outstanding shares may file a certificate of dissolution. Grounds for dissolution are assertions that the directors or those in control have guiltily engaged in illegal, fraudulent or oppressive actions toward the complaining shareholders or that the corporation's property or assets are being looted, wasted or diverted for non-corporate purposes by its directors, officers, or those in control.

In determining whether relief should be given, the court is required to determine whether liquidation is the only way for petitioners to reasonably expect to obtain a fair return on their investment, and whether such dissolution is reasonably necessary to protect the rights and interests of any substantial number of shareholders or petitioners. In addition to granting the right to examine the corporation's books and records, the court may order that stock valuations be adjusted and directors or those in control be surcharged upon a finding of willful or reckless dissipation or transfer of assets or property without just or adequate compensation.

The filing of the petition automatically triggers a right under section 1118 of the BCL by controlling shareholders or the corporation to elect to buy petitioner's shares at their fair value as of the day before the date on which the dissolution petition was filed, and for the court, upon application by respondents, to stay the 1104-a proceedings and hold a fair value hearing if the parties are unable to agree upon such value.

Let's assume that by contract, voluntary initiation by the parties or a judicial referral in a pending case a mediator is brought in to assist the parties in addressing their differences. It is often the case that because of the bad blood between the parties, neither desires to continue its business (and often its family) relationships with the other. The dissolution petition may be mostly petitioner's shot across respondent's bow designed to get respondent's attention to the abuses petitioners alleges. In the case of a mediator sought by the parties or by a judge, the mission is clear—to pay petitioner the fair value of its shares. How is the mission to be accomplished?

Fair Value Defined

Section 1118 offers no definition of fair value and some of the cases appear to conflate the terms "fair value" and "fair market value."[2] Most valuation practitioners believe that fair value ought to mean value of the minority holdings at the corporate level not at the shareholder level, a proportionate interest in the entirety of the company. Fair market value on the other hand is based on the theory of valuing closely held companies (originally for estate and gift tax purposes) that assumes willing buyers and sellers each having reasonable knowledge of the facts with neither being forced to conclude the transaction.[3] It views value at the shareholder level (value vis-à-vis other shareholders) and may, as in the case of New York, include a discount for lack of marketability but not for minority interest, also known as discount for lack of control.

Two important New York Court of Appeals cases *In the Matter of Seagroatt Floral Company*[4] and *Friedman v. Beway Realty Corp.*[5] set the contemporary stage for New York in permitting consideration of lack of marketability. In *Seagroatt*, a section 1118 case, the court noted that valuing a closely held corporation is not an exact science. Fair market value is a question of fact and will depend upon the circumstances of each case. "There is no single formula for mechanical application."

The Court of Appeals affirmed the Appellate Division's exclusion of a lack of marketability discount, and applied a 16 percent capitalization rate which an expert testified factored in lack of marketability. The rate was within range of the IRS's permissible capitalization rate for closely held companies.

Beway was a section 623 BCL case. Section 623 allows for an appraisal to determine the fair value of a disaffected minority's shares when the minority fails to agree with the corporate action taken by the majority. In *Beway*, the Supreme Court rejected petitioner's claim that no discount should apply and approved a marketability discount. However, it modified some of the discounts asserted by respondent's expert by refusing to recognize discounts due to stock transfer restrictions and minority interest. The Court of Appeals held that the financial analyses required for fair value purposes under section 1118 apply equally to section 623 proceedings, and remanded for the Supreme Court to determine how this affected the marketability discount.

It appears that New York courts in fair value cases allow for marketability discounts except when they don't. For example, in *Zelouf International v. Zelouf*,[6] the Supreme Court, New York County, rejected a rule requiring courts to mechanically apply a lack of marketability discount to all closely held companies. See also *Cole v. Macklowe*[7] in which the court denied defendant's motion in limine to allow its experts to testify concerning a lack of marketability discount because the action did not involve the sale of minority interests to third parties. The plaintiff was not a willing seller and fair value refers to plaintiff's proportionate interest in the company. The use of discounts "when selling to an 'insider' would result in a windfall to the transferee," said the court.

For contrary authority, *Ferolito v. AriZona Beverages USA*[8] was a section 1104-a and 1118 case involving two 50 percent owners of the subject company's stock. The Supreme Court, Nassau County, applied a 25 percent discount for lack of marketability based on the company's lack of audited financial statements, the extensive litigation between the parties, uncertainties about the company's

S-corporation status and transfer restrictions in the Owners Agreement (it is interesting to observe that in *Beway*, transfer restrictions in a similar kind of agreement were denied a marketability discount). Query, might not the deficiencies that supplied the rationale for the discount be addressed by a lower value before the discount was applied?

The Mediator's Role

The best way for a mediator to get started is to have an independent third party or parties value the interests in question. While it is helpful for the mediator to be familiar with going concern valuation techniques, the better to raise penumbras of doubt that become useful in caucus sessions, it is not a requirement, especially when each party has its own valuation expert to challenge the assumptions and valuation techniques of the other side's expert.

Valuation experts can be picked in a variety of ways—a single valuation firm, one sometimes recommended by the mediator, or a valuation firm selected by each side. If the mediation involves more than two parties that party might seek its own expert unless its position on value is likely to be substantially similar to that of another party. Should there be two or more valuation firms, their results could be averaged if they are within a certain range (say 10 percent) of each other. If not, the valuators could pick a firm whose valuation conclusion would be binding.

There could also be a circumstance in which the mediator was a valuation expert. In such a circumstance, the parties could agree to confer on the mediator, quasi-arbitral powers by authorizing the mediator to provide a non-binding advisory opinion on fair value to the parties. However, as in the case of a mediator's proposal generally, this is likely to be a last ditch initiative.

Next Steps

The next step involves the shuttle diplomacy of the caucus sessions with each side to reality-test the strengths and weaknesses of each side's valuation conclusion. Even if the mediator has rendered an advisory valuation opinion, he or she would have to candidly acknowledge that the number of judgment calls that make valuation an art and not a science could result in a materially different outcome in the hands of the ultimate trier of the facts than the conclusion suggested by the mediator.

Assessing Strengths and Weaknesses. In the valuation of minority interests in 1104-a and 1118 proceedings one will need to consider a variety of factors:

• What is the premise of value to be used? Is it going concern value (continued use as an ongoing operating business), value as an assemblage of assets (assets in place), orderly disposition value (value of assets sold individually and over time) or liquidation value (value in a forced liquidation)?

• What is the standard or value in section 1118 proceedings? It is fair value, discussed in greater detail above.

• Do earnings and cash flows of the closely held subject company need to be constructed (generally upward) to recognize private company accounting designed to minimize taxable income.[9]

• What are the valuation approaches to be used? There are three such approaches: Income (typically seen in the development of net present value through the use of discounted cash flow analysis), Market (typically a multiple of revenues or earnings seen in guideline company analysis), and Asset Value (typically seen in the net asset value approach that marks the subject company's assets and liabilities up or down from cost to fair market value).

• In general, what are the issues needed to be considered by the mediator by the caucuses under each of these three approaches?[10] In the case of discounted cash flow analysis, the issues include determining the company's cash flows, over how long a period these cash flows are to be measured, the rate at which the cash flows are to be discounted, and how the terminal or residual values (the value after the discounting period) shall be measured.

In the case of guideline company analysis, the issues to be considered include how closely the subject company compares to the comparatives in business operations and financial structure; how well or poorly the subject company's financial performance (growth in revenues and earnings, profit margins, returns on assets and equity, and balance sheet ratios) compares to those of the comparatives; and judgment calls on the appropriate revenue or earnings multiple to apply based on such data. In the case of the net asset value approach the issue is the persuasiveness of the financial data on which the fair market value of the assets and liabilities is premised and the extent to which a net asset value discount makes sense.

Finally, shall a lack of marketability discount apply and if so by how much?

Conclusion

This article has attempted to describe the disarray in the New York courts which seem to conflate fair value and fair market value, and sometimes apply discounts without persuasive force. One matter however is clear—whether a discount for lack of marketability should apply is a question of fact.

Mediation can be a time- and expense-saving approach in fair value contests under section 1104-a and section 1118 of the New York BCL or other statutory valuation situations. Success in such undertakings requires a sensible process for picking independent valuators of the subject interest. It also involves a mediator who, taking cues from the valuations report, persuades the parties that the valuation reports on which they rely may not hold water with the trier of the facts and that settlement might be a better option than continuing the time-consuming and expensive litigation process.[11]

Endnotes:

1. See *Weinberger v. UOP*, 452 A.2d, 701 (Del. 1983).

2. See Mitchell J. Geller, "Determining the Fair Value of Shares," New York Law Journal, Nov. 2, 2015.

3. Revenue Ruling 59-60. The "reasonable knowledge" portion of this rule is more apparent than real. Absent a management buyout scenario, the seller almost always has more reasonable knowledge than the buyer, which is why so many M&A transactions fail to live up to the buyer's expectations. See Arthur. H. Rosenbloom "Merger Failure and Deal Pricing," Westlaw Journal Mergers & Acquisitions, volume 26, issue 10, May 2016.

4. 78 N.Y.2d 439 (1991) See also, *Giamo v. Vitale*, 101 A.D.3d, 523 (1st Dept. 2012).

5. 87 N.Y.2d 161 (1995).

6. 2014 NY Slip Op. 24405 (Sup. Ct. New York Co.).

7. 2010 WL 7561613 (Sup. Ct. New York Co.).

8. 2014 NY Slip Op. 32830, 2014 N.Y. Misc. LEXIS 4709 (Sup. Ct. Nassau Co.).

9. For tax-minimizing purposes, management in closely held companies may be taking higher than normal compensation and travel and entertainment expenses or pricing inventory to increase the cost

of goods sold on the company's income statement, in all instances to minimize taxable income.

10. Each of these issues can give rise to great contentions in the battle of experts. It serves our purpose here simply to list these areas of contention.

11. Clearly it's much easier for the mediator to take cues from the rebuttal portions of expert reports in challenging each side to modify its position. Even so, however, I believe that a skilled mediator even if not experienced in valuation methodology can spot the judgment calls required in any valuation report.

Arthur H. Rosenbloom is an attorney and managing director of Consilium ADR, and can be reached at arthur@consiliumadr.com.

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