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 dissenting 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 dissenting 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 dissenting 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 dissenting 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 dissenting 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 dissenting 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 dissenting 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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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:
6. Ibid.
7. Ibid.
8. Ibid.
10. Ibid.

Entity-Level vs. Ownership-Level
Continued from page 62

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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