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

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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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