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Valuations: To Discount or Not To Discount

"Fair Value" in LLC Oppressed Member Cases

"Fair Market Value" is a term of art. Legally, it is defined as the price agreed to between a willing buyer and a willing seller both in possession of the facts and financially able. Another valuation standard is found in the corporate statutes of many states designed to protect smaller shareholders. This is a different measure which is called " fair value" under statutes designed to protect minority shareholders (and/or LLC members) when there is a squeeze out sale or exchange of all or substantially all the assets of the corporation or LLC. Before the enactment of statutes granting "appraisal rights," triggering transactions like mergers or acquisitions required unanimous consent. When the laws were changed to allow a majority or supermajority to endorse these triggering transactions, dissenting shareholders were granted appraisal rights in exchange.

The protection granted to minority shareholders or LLC members under these statutes is the right to force the company to buy them out and pay them the "fair value" of their shares. This remedy goes by many names: dissent and appraisal, dissenters' rights, or, simply, the appraisal remedy. Every state's corporate laws provide the protection in some form. It is generally thought that the same rights granted oppressed shareholders apply as well to minority members of LLCs. However, because limited liability companies are relatively new, there is very little case law addressing shareholder-level discounts as a part of an appraisal remedy pursuant to states' LLC Acts.

Nonetheless, the circumstances addressed by corporate dissenters' rights statutes are similar to those addressed by most LLC Acts because they generally provide for a judicially-ordered sale at "fair value," and the primary purpose is to compensate a member for the "involuntary deprivation of an investment."

Valuations: To Discount or Not To Discount, cont'd

How State Courts Have Ruled

Courts have held that a shareholder-level discount for lack of control in the corporate context is unnecessary because, under the applicable statutes, it is the company, not a third party, who is buying the membership interest.[1]

General Rule – No Discounts

Generally, in an appraisal rights remedy total enterprise value is the starting point for the valuation. This calculation is designed to factor out any discounts for minority interests (DMIN) or lack of marketability (DLOM) unless there are unusual circumstances. In 2000, in Indiana, in a compelled buyout case, an appellate court sided with the departing minority shareholder when it found discounts did not apply in a closed-market sale. But the Indiana Supreme Court (the State's highest court) reversed the appellate court, finding there was no blanket rule disallowing discounts in a compelled buyback, especially where the parties exercised a shareholder agreement whose terms suggested the use of fair market value.
New Jersey is one of several states that allow (but do not mandate) discounts for lack of control and marketability in fair value (oppressed shareholder) situations if it is proven that the discounts are fair and equitable. But, in a recent case, the trial court disallowed the discounts—and an appellate court agreed. The defendants argued that the discounts should be allowed based on the premise that the dissenting partners' dissociation was wrongful (and damages were owed to the partnership), so the discounts were fair and equitable. But the trial court did not find that the dissociation was wrongful, and the appellate court came to the same conclusion. Therefore, there was no justification to apply either discount.[2]

Minority Rule – Discounts Allowed

In most states, the merger statutes granting appraisal remedies to dissenting equity owners and the judicial dissolution statutes authorizing buyouts dictate the use not of the FMV standard but, rather, the legislative construct known as the fair value (FV) standard. Basically, the FV standard either statutorily or under judge-made law prohibits DLOC and DLOM.
But there can be a different definition for "fair value" for corporations (no discounts) and LLCs (discounts). In 2012, California amended its Corporations Code to adopt the Revised Uniform LLC Act (RULLCA) which provides in § 701(b) that, in dissolution cases based on oppressive, fraudulent, or illegal acts by the LLC's managers or controlling members, "the court may order a remedy other than dissolution." That may mean discounts in LLC cases but not in corporate cases. In *Pourmoradi v Gabbai*, an intermediate appellate court's 2-1 decision. [3] the Court chose to determine that the "fair market value" definition in the RULLCA required the use of discounts - DLOM and DMIN - in a "squeeze out" situation. The dissent disagreed saying there was no legislative history to show they meant to change the calculation for LLCs.

The seemingly neat distinction between the application of DMIN and DLOM, on the one hand, under the FMV standard derived from appraisal doctrine in non-statutory appraisal proceedings (allowed) and, on the other hand, the FV standard derived from legislative/judicial edict in statutory buyout proceedings (generally not allowed).

The Trial Court's Valuation in *Pourmoradi*

Pourmoradi involved a realty-holding LLC with two 50% members who deadlocked over whether to restructure a secured loan or sell the property. After the plaintiff filed for dissolution, the defendant elected to purchase the plaintiff's interest under § 17703.03. The

trial court appointed two party-nominated appraisers and a third, neutral appraiser to appraise the FMV of the plaintiff's membership interest.

The three appraisers agreed on a valuation of the real property but could not agree on the definition of FMV. The plaintiff-seller's attorney advised the appraisers that FMV as used in § 17703.03 was the equivalent of FV as used in § 2000 for close corporations and therefore excluded DMIN/DLOM. The defendant-buyer's attorney advised the appraisers that the definition of FMV was as set forth in IRS Revenue Ruling 59-60 and the ASA Business Valuation Standards and therefore allowed DMIN/DLOM. The three appraisers agreed that the (undiscounted) FV of the plaintiff's membership interest was a little under $5 million. The defendant's appraiser and the neutral appraiser respectively concluded FMVs of approximately $4 million and $4.25 million, respectively applying combined DMIN/DLOM discounts of 25% and 20%.

The trial court explained its decision as follows: "The sale of one partner's interest to the other partner would give the purchasing partner total control over the entire company. As such, a reduction for lack of control or lack of marketability would serve no purpose under this scenario. Such a reduction would only make sense if plaintiffs were selling their shares to some third-party purchaser who lacked control over the business affairs of the company. Accordingly, this court declines to apply the 15 percent reduction in value for lack of control and marketability."

The Appellate Majority Reverses

Defendant's appeal contended that the trial court erred in fixing the value of plaintiff's membership interest by applying a FV standard instead of the FMV standard required by the statute. Two of the three judges of the Court of Appeals agreed with the defendant, reversed the lower court's decree, and remanded the case for further proceedings consistent with the majority opinion.

The Dissent

The dissenting judge wrote that majority was using "an entirely artificial manner of analysis" in determining whether a hypothetical third-party "market participant" buying a 50% interest in the LLC would demand a discount due to "not [being able] to take action alone when the other 50 percent owner disagrees." Rather, where the defendant as purchaser "will end up with 100 percent control of the company," he urged,

"[t]here is no legal or practical justification for applying a lack of control or marketability discount in that circumstance. Indeed, if such a discount were applied, that would allow the purchaser to reap a windfall: the buyer need only pay the court-ordered, discounted price to obtain full control of the company and then, once in possession of full control and the premium it is worth, immediately turn around and sell the company to a third party at a higher price—laughing all the way to the bank to pocket the difference. The trial court understood that makes no good sense. As I read the record, the court believed some consideration of the equities was necessary to avoid an outcome in this particular factual scenario that the Legislature may not have foreseen but could not have intended."[4]

Delaware Chancery Court Cites Differences in Cash-Flow Assumptions as Cause for Large Discrepancy in Value

In a Delaware appraisal action to determine fair value, petitioner Ramcell Inc. exercised its appraisal rights in asking for a statutory appraisal of the value of its 155 shares of Jackson

Cellular Telephone Co. Inc. The respondent, Alltel Corp. (dba Verizon Wireless), had converted the 155 shares at a value of $2,963 per share. The 155 shares represented less than 10% of the outstanding shares of Jackson. “Respondent’s expert opines that Jackson’s per-share value was $5,690.92 at the time of the merger. Petitioner’s expert has offered two appraisal ranges, opining that, at the high end, Jackson’s per-share value was $36,016 on the merger date.” Both parties agreed that the DCF method should be the sole method for determining the value. The Delaware Chancery Court, using that method, determined the fair value of each share at $11,464.57. The court noted that the disparity in the parties’ valuations was due to disagreements as to the inputs to the DCF model and how they should be calculated.[5]

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[1] *See Charland v. Country View Golf Club, Inc.*, 588 A.2d 609, 612 (R.I. 1991) ("When a corporation elects to buy out the shares of a dissenting shareholder, the fact that the shares are noncontrolling is irrelevant."); *see also Hansen v. 75 Ranch Co.*, 957 P.2d 32, 41 (Mont. 1998). And a shareholder-level discount for marketability is equally unnecessary because, when valuing the company at the entity level, courts and valuation experts can and do account for the company's lack of marketability. *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137 at 1144 (Del. 1989); *see Brown v. Brown*, 792 A.2d 463, 475 (N.J. App. Div. 2002). Therefore, these discounts have the undesired effect of merely transferring, without compensation, a portion of the member's interest to the company. *Shawnee Telecom Resources, Inc. v. Brown*, 354 S.W.3d 542 at 555 (Ky. Sup. Ct. 2011).
[2] *Robertson v. Hyde Park*, 2022 N.J. Super. Unpub. LEXIS 848.
[3] No. B301009.Court of Appeals of California, Second District, Division Five.
Filed August 24, 2021. (NOT FOR PUBLICATION)
[4] For further discussion of this topic see Fox and Schaeffer, “Franchise Regulation and Damages” Section 20.02 and https://www.farrellfritz.com/rss-post/statutory-buyouts-and-discounts-under-the-fair-market-value-standard-an-awkward-pair/
[5] *Ramcell, Inc. v Alltel Corp.*, 2022 Del. Ch. LEXIS 312 (Oct. 31, 2022)

Damages

Chocolate Shop Franchisor’s Damage Award Melts on Appeal

In a dispute between a franchisor of chocolate shops and a franchisee, the U.S. Court of Appeals for the Eleventh Circuit has concluded that the federal district court in Florida improperly granted summary judgment in favor of the franchisor on breach of contract and unfair competition claims. The appellate court held that a trial is needed because genuine issues of material fact exist whether the franchisee’s breach of the franchise agreement concerning its obligation to install a required point of sale (POS) system was material.[1]

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[1] *Peterbrooke Franchising of America, LLC v. Miami Chocolates, LLC*, 11th Cir., CCH Business Franchise Guide ¶17,199

Quotations

“Those who cannot remember the past are condemned to repeat it.” - George Santayana

“God fights on the side of the larger battalions." - Napoleon