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Value & Cents II

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What Is Fair Value? It Depends

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The need for business valuation arises across a variety of litigation contexts. A nonexhaustive list of these situations might include, in addition to bankruptcy and restructuring matters, interests and claims in antitrust, breach-of-contract, environmental, tax, mergers and acquisitions, intellectual property, international arbitration, securities and statutory appraisal proceedings. Along with differences in financial, legal and jurisdictional precedents and standards, the complexity of these matters is, at times, compounded by the mixing and matching of terms and methodologies in statutes and by courts, counsel and valuation practitioners to derive an opinion of value. A prime example is the sometimes interchangeable use of the term "fair market value" to describe fair value and vice versa, regardless of context. Understanding what is meant by the fair-value standard and how it is properly applied within a given situation is critical, however, as a failure to do so can result in significant differences in valuation and related outcomes.

Fair Value in Bankruptcy and Restructuring

In bankruptcy and restructuring contexts, the language used to describe the appropriate type or standard of value used by bankruptcy judges to adjudicate value differs from what is commonly used to define the appropriate standards of value encountered elsewhere. For example, in valuations prepared for tax, financial-reporting and investment purposes, it is common to apply the fair market value, fair value and investment valuation standards. Each of these standards is defined in the valuation literature or similarly described in standards defined in the Internal Revenue Code and Treasury Regulations, or by professional associations including the American Society of Appraisers, Association of Insolvency and Restructuring Advisors and American Institute of Certified Public Accountants (AICPA), together with valuation approaches and methods that may be used if and as appropriate.

By comparison, the fair valuation, present fair saleable value, reasonably equivalent value, fair consideration and reorganization value standards that are required in bankruptcy are not as well defined, if at all, in the Bankruptcy Code, state statutes, valuation literature or professional association standards. For example, 11 U.S.C. § 101(32)(A) of the Bankruptcy Code defines insolvency from a balance sheet perspective generally and in part as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a *fair valuation*." Fair valuation is also the type of value referred to in § 2(a) of the Uniform Fraudulent Transfer Act (UFTA) for the purposes of evaluating solvency, although in states where it has not been superseded, the Uniform Fraudulent Conveyance Act (UFCA) provides that a debtor is insolvent if its debts exceed the *present fair saleable value* of its assets.

Further, to establish a constructive fraudulent transfer or conveyance claim, the UFTA requires a showing that the debtor did not receive *reasonably equivalent value* in exchange for the transfer that was made or the obligation that was incurred, while the UFCA requires a demonstration that the debtor did not receive *fair consideration*. Although not specifically identified as a requirement of the Bankruptcy Code, the development and confirmation of a reorganization plan under § 1129 may also require a determination of the debtor's *reorganization value*, which the AICPA generally describes as the *fair value* of the debtor prior to taking into account its liabilities, and which approximates what a willing buyer would pay to acquire the assets of the debtor immediately after its emergence from bankruptcy.

The valuation approaches and methods that should be used if and as appropriate to derive an opinion of value in bankruptcy, insolvency and restructuring matters are also not specifically iden-

tified. For example, as § 506 of the Bankruptcy Code states, "value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." That being the case, the valuation of a business in a bankruptcy proceeding is a dynamic process subject to legal precedents that continue to develop and in which courts adjudicate value, taking into consideration the facts and circumstances surrounding the debtor's past and future prospects, which may change over the pendency of the case.

Notwithstanding, certain guidelines have developed in case law over time, with the fair valuation, present fair saleable value, reasonably equivalent value, fair consideration and reorganization value standards referencing or generally interpreted to mean the fair market value of the business. Accordingly, in Treasury Regulation § 20.2031-1, the most common definition of "fair market value" is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

Underlying this standard, the willing buyer and willing seller are typically interpreted to be independent, hypothetical participants in the market for comparable businesses, dealing at arm's length, with the ability to transact (assuming a sale transaction) at a price equitable to both, with the economic and market conditions existing as of the date of the valuation.[1] Premiums or discounts attributable to the degree of ownership control, liquidity and/or marketability may also be applied as appropriate given the level of value inherent to the subject interest, whether strategic, financial control, marketable, minority or non-marketable, minority level. However, a price influenced by the specific motivations, characteristics, requirements or synergies of a particular buyer or seller would not be consistent with fair market value, as would also be the case for a price observed in an illiquid and inefficient market, or resulting from a sale process lacking active and competitive bidding.

In bankruptcy situations, case law indicates that the taint of bankruptcy should be excluded from the valuation of a business in recognition of the fact that market participants may offer less for a company in distress than the value derived from its expected cash flows. Similarly, the approaches and methods found to be relevant and relied upon by bankruptcy judges in adjudicating value have been those accepted and commonly used in the market, namely the discounted cash flow, guidelines for a publicly traded company and guideline transaction methods. In conjunction, based on the presumption in bankruptcy that enterprise value is greater than liquidation value, the *operational premise* of value underlying a chapter 11 proceeding is implicitly that of a going concern, or an assembled group of income-generating assets, accounting for the contributory relationship between tangible and intangible assets. By comparison, the *operational premise* of value implied in a chapter 7 case is that of a liquidation, in which case the assets of the business are sold piecemeal, in an orderly or forced manner, or in place but not in use to produce income as part of a going concern.

1 The valuation premise implied in a real or hypothetical sale transaction is that of value in exchange. Alternatively, the valuation premise that is applicable to a business or interest maintained as-is by its present owner is that of value to the holder, which may be more or less than the value of a property in exchange.

Fair Value in Shareholder Dissent and Oppression

A shareholder who finds that a corporate action, such as a merger,[2] share exchange or amendment to the articles of incorporation, will eliminate or otherwise adversely affect their interest in the corporation, may under the appraisal remedy, dissent from the action, petition to have their shares judicially appraised and demand that the corporation purchase their shares at the appraised value. Relatedly, in states that have minority oppression statutes under which shareholders who believe that they have been treated unfairly or prejudicially (*e.g.*, by a breach of fiduciary duty, termination of dividends or diversion of corporate assets for the benefit of the majority) may petition to dissolve the corporation and regain what was taken from them, in which case the corporation may choose to purchase the shares or be ordered by the court to do so, and pay any equitable adjustment deemed necessary.

> **Superficial semblances aside, fair value in dissent and oppression is clearly not the indubitable equivalent of fair value in bankruptcy.**

Like in bankruptcy, the standard of value applied in both circumstances is fair value, as established by statutes and interpreted in case law that has evolved over time. Unlike in bankruptcy, however, the legal constructs underlying assumptions and derivations of fair value in dissenting shareholder and minority oppression is different from fair market value, with most states following some permutation of the definition of "fair value" that has been provided in the American Bar Association's Revised Model Business Corporation Act (RMBCA).

Beginning in 1984, the RMBCA defined "fair value" as "the value of the shares immediately before the effectuation of the corporate action to which the shareholder objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable." Subsequently, in 1999, the RMBCA's definition of "fair value" was revised to mean "the fair value of the shares 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, and without discounting for lack of marketability or minority status except, if appropriate, for amendments to the certificate of incorporation pursuant to section 13.02(a)(5)."

As between the states, most use the 1984 definition, a few use the 1999 revision or a mix of the 1984 and 1999 revision, and a minority use the 1984 definition but delete the phrase "unless exclusion would be inequitable" while adding, as in

2 For example, in a freeze-out merger, a firm's controlling shareholders create a shell corporation, transfer all of their stock to that entity and then agree to merge their original firm with the shell. As a consequence of the merger, the former shell acquires the assets and liabilities of the original firm, the controlling shareholders own all of its stock and the minority shareholders in the original firm are left with nothing but the right to receive cash for their former interest.

the case in Delaware, that all relevant factors be considered. Perhaps as a consequence of this divergence, most states look to Delaware case law for guidance in dissenting shareholder litigation, adopting all or some of the opinions of the Delaware Court of Chancery and Supreme Court.

In Delaware, the statutory description of fair value is given in title 8, § 262(h) of the Delaware General Corporation Law, which provides that a court "shall determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with interest, if any, to be paid upon the amount determined to be the fair value. In determining such fair value, the Court shall take into account all relevant factors." Interpreting this guidance, Delaware courts have held fair value to mean "the value of the petitioner's shares on the assumption that they are entitled to a *pro rata* interest in the value of the firm when considered as a going concern, specifically recognizing its market position and future prospects,"[3] with the court of chancery noting that "[t]he concept of fair value under Delaware law is not equivalent to the economic concept of fair market value. Rather, the concept of fair value for purposes of Delaware's appraisal statute is a largely judge-made creation, freighted with policy considerations."[4]

Accordingly, unlike what might be an indication of fair market value in bankruptcy depending on the underlying facts, the merger price is not a relevant indication of fair value in shareholder dissent and oppression. In *Golden Telecom*, the Delaware Supreme Court found that § 262(h)

> unambiguously calls upon the Court of Chancery to perform an independent evaluation of "fair value" at the time of the transaction. It vests the Chancellor and Vice Chancellors with significant discretion to consider "all relevant factors" and determine the going concern value of the underlying company. Requiring the Court of Chancery to defer "conclusively or presumptively" to the merger price, even in the face of a pristine, unchallenged transactional process, would contravene the unambiguous language of the statute and the reasoned holdings of our precedent. It would inappropriately shift the responsibility to determine "fair value" from the court to the private parties.[5]

To apply discounts for lack of control and marketability, or premiums for control at the shareholder level, is also improper, except perhaps in the valuation of shares using the guideline publicly traded company method. In *Cavalier Oil*, the chancery court held in part that "[t]he purpose of a Delaware Appraisal is to determine the fair value of 100% of the corporation, and to award to the dissenting stockholder his proportionate share of that fair value. The objective is not to value a specific minority stock interest in the corporation as such."[6] In affirmation, the Delaware Supreme Court explained further that "[t]he application of a discount to a minority shareholder is contrary to the requirement that the company be viewed as a 'going concern.'… Where there is no objective market data available, the appraisal process is not intended to reconstruct a *pro forma* sale but to assume that the shareholder was willing to maintain his investment position, however slight, had the merger not occurred.… [T]o fail to accord to a minority shareholder the full proportionate value of his shares imposes a penalty for lack of control, and unfairly enriches the majority shareholders who may reap a windfall from the appraisal process by cashing out a dissenting shareholder, a clearly undesirable result."[7]

Fair value also *does not* include synergies that have been *planned by the buyer*. In *Golden Telecom*, the chancery court found that "any synergies or other value expected from the merger giving rise to the appraisal proceeding itself must be disregarded."[8] As qualified in *Weinberger*, however, "elements of future value, including the nature of the enterprise, which are known or susceptible [to] proof as of the date of the merger and not the product of speculation, may be considered."[9] In addition, the valuation premise underlying fair value is value to the holder, while the operational premise is a going concern. Fair value may also be determined "by any techniques or methods [that] are generally considered [to be] acceptable in the financial community and otherwise admissible in court,"[10] with the most prominent being the discounted-cash-flow method,[11] with the guideline publicly traded company[12] and comparable transaction method used as well.[13]

Conclusion

Superficial semblances aside, fair value in dissent and oppression is clearly not the indubitable equivalent of fair value in bankruptcy. Neither the buyer nor seller are willing, with one being forced to buy and the other coerced to sell. Moreover, rather than assuming a sale in a market for comparable businesses, fair value assumes that the petitioner would have held onto their shares but for the transaction. Further, there is no assumption — implicit or otherwise — that the merger price, which may be influenced by the very action to which the petitioner objects, is equitable to either party. Rather, depending on the facts of the particular case, fair value may be adjudicated to be higher or lower than either the merger price or fair market value. Recognizing and understanding how these differences are properly handled is consequently crucial to deriving the proper measure of value and averting the consequences of a valuation being dismissed. abi

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3 *Finkelstein v. Liberty Digital Inc.*, C.A. No. 19598, 2005 Del. Ch. LEXIS 53, at *39 (Del. Ch. April 2005), (citing *In re Shell Oil Co.*, 607 A.2d at 1218 (Del. 1992), and *Tri-Continental Corp. v. Battye*, 74 A.2d at 72 (Del. 1950)).

4 *Finkelstein*, 2005 Del. Ch. LEXIS 53, at *39. *See also Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Grp. Ltd.*, 847 A.2d 340, 356 (Del. Ch. 2003).

5 *Golden Telecom Inc. v. Global GT LP*, 11 A.3d 214, 217-18 (Del. 2010).

6 *Cavalier Oil Corp. v. Harnett*, C.A. Nos. 7959, 1988 Del. Ch. LEXIS 28, at *28 (Del. Ch. Feb. 22, 1988).

7 *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1145 (Del. 1989).

8 *Global GT LP v. Golden Telecom Inc.*, 993 A.2d 497, 507 (Del. Ch. 2010).

9 *Weinberger v. UOP Inc.*, 457 A.2d 701 (Del. 1983).

10 *Id.* at 713.

11 *Highfields Capital*, 939 A.2d at 52; *Crescent/Mach I P'ship*, 2007 Del. Ch. LEXIS 63, at *33; *Andaloro*, 2005 Del. Ch. LEXIS 125, at *78, *Cede & Co. v. JRC Acquisition Corp.*, C.A. No. 18648-NC, 2004 Del. Ch. LEXIS 12, at *6 (Del. Ch. Feb. 10. 2004).

12 *Highfields Capital Ltd. v. AXA Fin. Inc.*, 939 A.2d 34, 56 (Del. Ch. 2007).

13 *Id.* at 54.