MINORITY SHAREHOLDERS RECEIVE A CHRISTMAS GIFT FROM THE GOVERNOR

by Derek P. Usman, Usman Law Group, P.C., Chicago

Effective January 1, 2007, amendments to the Illinois Business Corporation Act now provide a more precise definition of the fair value of minority interests. The new Illinois legislation is quite similar to the 1999 amendments to the Model Business Corporation Act. The Illinois Business Corporation Act now explicitly states that "fair value…means the proportionate interest of the shareholder in the corporation, without any discount for minority status or, absent extraordinary circumstances, lack of marketability."

Prior to 2007, "fair value" proceedings in Illinois courts have often resulted in the application of minority and marketability (liquidity) discounts. Even though the Illinois Supreme Court repeatedly discouraged the use of discounts, the position of trial courts remained inconsistent with the majority of courts throughout the country that disallowed discounts. Also, while other states considered discounts to be a question of law, Illinois considered the appropriateness of discounts as one of fact. During "fair value" proceedings, Illinois trial courts left the calculation of fair value to valuation experts and subsequently, the appellate courts deferred to the trial courts. Nevertheless, the newly enacted legislation explicitly prohibits the application of discounts in calculating the fair value of minority shares.

"Fair value" proceedings arise to resolve conflicts between the majority and minority shareholders where the controlling shareholders would benefit at the expenses of the minority shareholders. For example, a conflict is present when a minority interest is discounted in a merger or stock restructuring but the majority interest ends up retaining the discounted value after the reorganization. As a potential remedy, Section 8.60 of the Illinois Business Corporation Act requires the majority shareholders to demonstrate that a fair value was provided for the minority interests.

Sections 11.65 and 11.70 of the Illinois Business Corporation Act provide for dissenter's rights to a shareholder of a corporation by allowing the shareholder to obtain payment for his shares in the event of certain corporate actions. Alternatively, the presence of oppressive conditions also avails remedies to an injured shareholder. Upon satisfying any of the conditions listed under Section 12.56(a)(1)(4), a petitioning shareholder of a private corporation may request judicial intervention. Subsequently, a possible remedy for the statutorily defined oppressive situations includes a court ordered share purchase after a determination of the fair value of shares.

As a starting point, the "fair value" standard must be distinguished from the "fair market value" standard in analyzing the reasoning behind prohibition of minority discounts in "fair value" proceedings. Illinois courts have stated that fair market value is "based on the price that would be agreed upon in an arms length transaction between a willing buyer and willing seller on the open market, neither under a compulsion to act, and both parties possessed of all relevant facts". Furthermore, the fair market value standard is used in gift and estate tax valuations where minority and liquidity discounts are routine. On the other hand, fair value is often calculated for interests purchased by the remaining shareholders of an entity and the fair market value is inapplicable. The two standards are not analogous; nor are they utilized under similar circumstances. Therefore, the application of discounts is not necessarily appropriate under the "fair value" standard.

Still yet, a minority discount adjustment is based on the theory that non-controlling shares are not worth their proportionate share of the company's value because they lack voting power to control corporate actions. On the other hand, a marketability discount is an adjustment for a lack of liquidity. Here the theory is that there are a limited number of potential buyers for the stock of a closely-held corporation. However, minority and marketability discounts are inappropriate when the purchaser of the stock is either the majority shareholder or the corporation itself. The application of a minority discount is not appropriate because different interests are present when a there is a sale to an outside third party. Upon a sale to a third party, the value of the shares remains constant or drop in value because the third party does not gain a right to control or manage the corporation. On the other hand, a sale to a majority shareholder or to the corporation increases the interests of those already in control. Consequently, the application of a minority discount in a sale to "insiders" would result in a windfall to the buyer.

Nevertheless, litigation is still inevitable because there is a lack of legislative history that discusses exactly when the statutory exception for "extraordinary circumstances" warranting a discount for lack of marketability arises. So, just what will these extraordinary circumstances entail? Even though the amended statutes are void of any guidance, the American Law Institutes' Section 7.22 of the Principles on Corporate Governance is a good starting point. Illinois' newly adopted definition of fair value mirrors the American Law Institute's definition of fair value. The ALI endorses the national trend of interpreting fair value as the proportionate share of a going concern "without any discount for minority status or, absent extraordinary circumstances, lack of marketability." The ALI has further recommended that to determine fair value, the trial court must determine the aggregate value for the firm as an entity, and then simply allocate that value pro rata in accordance with the shareholders' percentage ownership.

Similar to Illinois, the ALI's definition of fair value also includes the exception for "extraordinary circumstances". Unlike the Illinois statute, the ALI provides guidance as to just when extraordinary circumstances might arise. Comment e to Section 7.22 clarifies that extraordinary circumstances must consist of more than an absence of a trading market in the shares. Furthermore, an ALI comment states that the extraordinary circumstances exception is "very limited" and is intended to apply only when the trial court "finds that the dissenting shareholder has held out in order to exploit the transaction giving rise to appraisal so as to divert value to itself that could not be made available proportionately to other shareholders."

The comment also provides an example of "extraordinary circumstances". In the example, a financially strained corporation lacking liquid assets makes relatively minor changes in its governance and structure which trigger appraisal rights. Since the corporation is financially troubled and only has illiquid assets, a fair value appraisal proceeding would likely result in a higher price per share than a market transaction for the shareholder's shares. Furthermore, a shareholder dissents because he had been unsuccessfully attempting to persuade the other shareholders to purchase his shares. Therefore, the dissenting shareholder now has the opportunity to obtain a much higher price for his share by exploiting a relatively minor change. A marketability discount would be proper because the "fair value" proceeding is likely to produce an appraisal higher than the remaining shareholders could receive upon a sale of the corporation or its assets and the dissenter is taking advantage of a minor corporate change. Therefore, if a dissenting shareholder does not have a valid objection to the transaction, the shareholder is deemed to be exploiting a minor change in the charter. Consequently, a marketability discount should be applied to prevent an unfair wealth transfer to the dissenting shareholder. The comment does indicate that under identical facts, if the shareholder dissented to a fundamental corporate change, such as a merge, a marketability discount would be inappropriate.

In 2003, the Colorado Supreme Court analyzed the ALI's definition and interpretation of "fair value" and "extraordinary circumstances" and asserted that that the "extraordinary circumstance" exception is intended to enable trial courts to utilize their equitable powers and provide a fair result when extraordinary circumstances are present. (For brevity's sake I'm excluding a discussion of cases that analyze the applicability of the "extraordinary circumstance" exception. Nevertheless, all of those cases emphasize the limited nature of the exception.)

In addition to the strict statutory limitations on discounting minority shares, courts across the nation have recognized that discounts unjustly benefit the majority shareholders. As the Delaware Supreme Court stated in the leading "fair value" case in Cavalier Oil Corp. v. Harnett, "…to fail to accord to a minority shareholder the full proportionate value of his shares imposes a penalty for lack of control, and enriches the majority shareholders who may reap a windfall from the appraisal process by chasing out a dissenting shareholder, a clearly undesirable result."