Dissenters' Rights: Litigating "Fair Value"
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What are dissenters' rights, and why do they exist?

There is a general feeling among transactional lawyers that corporate shareholders are becoming more and more likely to assert their right to "dissent" from a corporate transaction and liquidate their shares. While it is hard to prove or disprove whether this feeling is accurate, it is nevertheless useful to understand the nature of the right to dissent and to examine some of the issues these claims present in litigation.

In an earlier era, corporate law required shareholders to vote unanimously in favor of major changes to a corporation's structure or operations. As a result, a single shareholder could thwart a deal, regardless of how good it was for the entire ownership. On the other hand, the unanimity rule protected the individual shareholders, who had no legal right to liquidate their shares in the face of a transaction they did not like. Over time, though, the unanimity requirements were loosened, and today a simple majority of shareholders can make most corporate decisions. In theory, this change gave a company's ownership the flexibility it needs to take advantage of opportunities that might otherwise be missed because of single holdout. But with that flexibility came the risk that controlling shareholders will exercise their power at the expense of the minority.

Two scenarios are distressingly common. Imagine that Tom, Dick, and Harry are equal owners of Pin Heads, Inc., which owns a chain of bowling alleys. If Tom and Dick decide to cut Harry out of the business against his will, all they have to do is form another corporation without Harry and then vote to sell Pin Heads' assets to the new entity, leaving Harry out in the proverbial cold.[1] This is the classic "freeze out" or "squeeze out" situation. Worse, if Tom and Dick sell Pin Heads' assets to their new company for less than market value, they haven't just frozen Harry out of the operation, they have stolen his equity as well.

Consider another scenario: Pin Heads has done well and is now worth $3 million. Our three shareholders reasonably expect to receive $1 million each if the company is sold. Because they are in control, Tom and Dick negotiate the sale of the company's assets to an unrelated buyer for just half a million dollars, which will eventually be distributed to the shareholders equally. At the same time, Tom and Dick negotiate sweetheart agreements with the buyer just for themselves. These agreements might require Tom and Dick to provide "consulting" services to the buyer, or not to compete with the buyer, or maybe both. In return for these commitments, the buyer will pay Tom and Dick—you guessed it—$1.25 million each. (Harry, of course, isn't offered a contract.) Tom and Dick's agreements may not have any real value to the buyer, but that is exactly the point. The contracts are

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[1] *See* Note, Freezing Out Minority Shareholders, 74 Harv. L. Rev. 1630 (1961); *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 3 fn. 1 (1985)(discussing squeeze-out mergers).

a sham that Tom and Dick have created to divert money from the buyer to themselves when it ought to have gone to the corporation as a whole. Harry is again left out in the cold.

To protect Harry and his fellow minority shareholders, most states—including Georgia—passed statutes allowing a shareholder to "dissent" from certain corporate transactions that change the fundamental nature of the business and to liquidate his shares for their "fair value."[2] In Georgia, the right to dissent is available both to shareholders of corporations and members of limited liability companies[3], and it is triggered most often when there is a merger or asset sale.[4]

When there is such a transaction, the company must notify the shareholder of the transaction and his right to dissent. The dissenting shareholder then notifies the company of his intent to dissent.[5] After receiving notice that a shareholder dissents, the corporation must offer the shareholder what it believes to be the fair value of the shareholder's interest, along with certain financial information supporting that valuation.[6] The shareholder can either accept the corporation's offer or counter with his own valuation. But if the shareholder and the corporation cannot come to an agreement, the corporation must institute a court action to determine the fair value of the dissenter's shares. The valuation proceeding is a nonjury, equitable hearing, so it must be brought in the superior court.[7] Although it presents some opportunities for either party to stumble, this basic procedure is not terribly complicated. The bigger challenge by far is proving fair value.

What is "fair value"?

The Georgia Code defines fair value as "the value of the 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."[8] This definition is remarkably circular, and there is almost no Georgia case law expanding the meaning of fair value. However, the little authority that does exist establishes that "a shareholder should generally be awarded his or her proportional interest in the corporation after valuing the corporation as a whole."[9] In effect, the

[2] The history and theory behind dissenter's rights is treated at length in Barry M. Wertheimer, The Purpose of the Shareholders' Appraisal Remedy, 65 Tenn. L. Rev. 661 (1998).
[3] O.C.G.A. § 14-2-1301 *et seq*. (corporations); O.C.G.A. § 14-11-1001 *et seq*. (LLCs). Because the two statues are substantively identical, we will refer only to the Business Corporation Code.
[4] O.C.G.A. § 14-2-1302.
[5] O.C.G.A. § 14-2-1320 to 1324.
[6] O.C.G.A. § 14-2-1325.
[7] O.C.G.A. § 14-2-1330(b).
[8] O.C.G.A. § 14-2-1301(5).
[9] *Blitch v. Peoples Bank*, 246 Ga. App. 453, 457 (2000).

"fair value" of a minority interest may be different from the "fair *market* value" of that same interest.

To illustrate, assume Pin Heads is worth $3 million. On the open market, Harry's one-third interest in the company would likely be worth less than $1 million. After all, with partners like Tom and Dick, who would want to buy Harry's shares? But under the dissenter's rights statute, Harry would be entitled to his pro rata portion of the company's value, without any discounts to account for the lack of marketability or control associated with his individual shares—that is, $1 million.[10] This is an important point, but it still leaves us with the task of determining the value of the company as a whole.

Because there is so little Georgia authority on this point, the practitioner must look to other sources for guidance.[11] Fortunately, it is generally agreed that a dissenting shareholder is entitled to be compensated for what he has lost, which is an interest in a "going concern" and not just a share of the corporation's liquidated assets. As such, he is entitled to his share of the company's "intrinsic" value—that is, the present value of all future benefits that would flow to the company's owners from its operations—not just the price the company would bring if it were sold.[12]

This conceptual difference between intrinsic value and market value is not always obvious to parties or to courts. Moreover, the distinction is blurred by the fact that, as a practical matter, the intrinsic value and market value of a given company will often coincide (a point we will return to below). Nevertheless, the practitioner must remember that these are two distinct measures of value.[13]

Proving Value: Cash flows and multiples.

Business valuation is an established field that exists separate and apart from any role it plays in dissenters' rights cases, but its tools are essential to the

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[10] *Id.*

[11] Delaware in particular has a well-developed body of case law on the issue of fair value in the context of dissenter's rights. Further, the Georgia statute is based on the original Model Business Corporations Act, the comments to the Model Act are useful as guidance. *Blitch v. Peoples Bank*, 246 Ga. App. 453 (2000). Although the Model Act has been amended since the Georgia statute was passed, the Georgia Court of Appeals has even looked to the changes in the Model Act for guidance. *Id.*

[12] *See Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182 (Del. 1988)(equating "fair value" and "intrinsic worth"). In *Atlantic States Construction, Inc. v. Beavers*, 169 Ga. App. 584 (1984), the Georgia Court of Appeals adopted intrinsic value as the standard for fair value. However, that opinion is only physical precedent, and it has been abrogated in other respects by later opinions. *Blitch*, 246 Ga. App. at 457 fn. 21.

[13] *See Cede & Co.*, 542 A.2d at 1188 fn. 8 (noting that market price may not reflect intrinsic value).

dissenters' rights process.[14] The litigator must be comfortable enough with business valuation techniques to understand why each expert has chosen a given tool and how his conclusions would change if a different tool were used.

Mainstream valuation theory rests on the idea that the intrinsic value of any financial asset, such as a share of corporate stock, is the product of the expected cash flows its owner will receive, on a risk-adjusted basis. Therefore, the value of a business is a function of the money it is expected to make in the *future*, not the money it has made in the past. This can seem counterintuitive, especially because we are accustomed to hearing businesspeople and financial analysts speak about companies' values in terms of some multiple of their past revenues or profits. But it is important to remember that these multiples are a reflection of the likelihood that a company's past performance (good or bad) will continue in the future. So, even when it is defined in terms of past performance, value is still fundamentally about the future.

Business valuation, then, is inherently forward-looking, and this forward-looking orientation distinguishes it from other related disciplines. Accounting, for example, is a system for recording financial transactions that have already happened, so by its very nature it is backward-looking. This is not to say that accounting is not a part of valuation. In fact, accounting information is absolutely necessary for valuation. But financial statements and other accounting data on their own are merely necessary for performing a proper valuation. They are never sufficient.

The business valuation profession recognizes various *approaches* for valuing a company. Two of these approaches—the "income approach" and the "market approach"—are typically the most useful for determining the value of company as a going concern. Within these approaches there are various *methods*, but as a practical matter the litigator will generally only encounter three of them.

Under the income approach, the "discounted cash flow" (or "DCF") method is the one most commonly encountered in litigation matters. A DCF analysis is used to forecast or project a company's future cash flows—and therefore its intrinsic value—directly. It involves two steps: First, the expert must identify (or produce) reliable projections of the company's future cash flows. Then, she must "discount" those earnings to their present value in order to take into consideration the time value of money and the risk that the expected cash flows may never materialize.

The DCF method is widely accepted, so much so that an expert must have a

[14] The current version of the Model Business Corporations Act, for example, provides that fair value is to be determined "using customary and current techniques generally employed for similar businesses in the context of the transaction requiring appraisal." MBCA, § 13.01(4)(ii).

good reason for not performing a DCF analysis or risk having his opinions as a whole discarded.[15] Nevertheless, the DCF method is not flawless. For one thing, it is generally disfavored for the expert to create his own projections for the purpose of performing a DCF analysis. It is far more credible for the expert to use projections that were created either by company management or by a third-party for reasons unrelated to the litigation.[16] But not every company has projections that are independent of the litigation matter, so often a DCF analysis simply can't be done.

Even if projections are available, some caution must be exercised before they are blindly adopted by an expert. For a DCF analysis to have any value, the projections that are used must be both reliable and current as of the valuation date.[17] If favorable projections exist, a dissenting shareholder can almost be certain that the company will claim there was some reversal of fortune between the date of the projections and the date of the valuation that renders the projections useless. Similarly, if the projections were created primarily to attract investors and not to guide management decisions, it is very possible that they are unreasonably optimistic and so can't be used without some sort of adjustment.[18] It is the litigator's job to determine, through careful fact discovery, the reliability of any projections before they become the basis of an expert's opinion. Again, although the DCF method is not always available, it must always be considered.

In contrast to the DCF method (and income approach generally), the market approach is an indirect measure of value. The market approach assumes that markets are reasonably efficient and therefore the prices at which companies (or shares of companies) sell are generally an accurate reflection of their intrinsic value. There are different methods under the market approach, but at a high level they all contain the same basic elements. First, the expert identifies companies that are similar or "comparable" to the company in question. By comparing the market value of these companies to some common financial metric, such as earnings, the expert can create a ratio or "multiple," which can then use to estimate the market value of the subject. For example, if we wanted to value our fictional company Pin

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[15] *See, e.g., Lippe v. Bairnco Corp.*, 288 B.R. 678, 689 (S.D.N.Y. 2003) aff'd, 99 F. App'x 274 (2d Cir. 2004); *In re Med Diversified, Inc.*, 334 B.R. 89 (Bankr. EDNY 2005).

[16] *See In re ISN Software Corp. Appraisal Litigation*, 2016 WL 4275388 at *5 (Del. Ch. 2016)(experts' creation of projections "inherently less reliable than using long-term management projections"); *In re Radiology Assocs., Inc. Litig.*, 611 A.2d 485, A.2d 490–491 (Del. Ch. 1991)(discussing need for projections not created by expert).

[17] *See Highfields Capital, Ltd. v. AXA Financial, Inc.*, 939 A.2d 34 (Del. Ch. 2007)(favoring DCF that relied on current management projections over analysis that relied on outdated projections).

[18] *See In re Appraisal of Ancestry.com, Inc.*, 2015 WL 399726 (Del. Ch. 2015)(rejecting valuations based on projections that were not created in the ordinary course of business, but only to attract buyers).

Heads, our expert would first look at companies similar to Pin Heads that have recently sold. If companies similar to Pin Heads have recently sold for three times their annual earnings, our expert can then infer that Pin Heads would also sell for three time its annual earnings.

There are two principal methods for applying the market approach. One uses publicly traded companies as comparables (the guideline public company method), and the other looks at sales of privately held companies (the guideline merged and acquired company method). Both methods present similar challenges. The first of these is identifying which companies, if any, are truly "comparable" to the business at issue. If you are trying to value a company that owns bowling alleys, you aren't likely to find another chain of bowling alleys that has sold recently, so you will have to cast your net more widely. Would a chain of go-cart tracks be sufficiently similar to the bowling alley business? What about amusement parks? Unfortunately, there is no objective measure of comparability, and you will quickly find that a certain amount of subjectivity is unavoidable. An unscrupulous expert can use his discretion to select comparables that push the data toward a conclusion that favors his client.

The second challenge is creating the right multiple. Even if an expert has chosen comparable companies that are in the same general business as the subject company, they will differ from each other (and the target company) with respect to fundamental financial characteristics, such as their size, growth potential, and riskiness. Each of these differences will affect a company's future prospects, so the expert cannot just simply calculate the comparable companies' multiples and then mechanically apply the average to the subject company. Instead, she should try to determine how, and to what degree, the subject company differs from those in her set and adjust her final multiple accordingly. In theory, an expert might consider an elaborate multi-variable regression analysis to identify which fundamental characteristics have an effect on value and the relative significance of each. In practice, this almost never happens, and multiples must be adjusted by less formal methods. Unfortunately, an expert often adjusts his multiples by relying only on his own subjective "judgment."[19] The opportunities to abuse this process are obvious.

This discussion may seem to paint an unfairly cynical picture of valuation practice. After all, these techniques guide the allocation of enormous sums of capital in the financial markets, and they are regularly accepted as valid by courts in all sorts of cases involving the value of businesses. Nevertheless, the litigator is wise to

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[19] *See, e.g., Merion Capital, L.P. v. 3M Cogent, Inc.*, 2013 WL 3793896, at *23 (Del. Ch. 2013)(rejecting expert's choice of multiples based only on professional "judgment call"); *In re IH 1*, 2015 WL 5679724 (D. Del. 2015)(rejecting opinion of expert who made "judgment call" to reduce comparable multiples by 50% without any explanation).

remember that valuation is ultimately as much "art" as it is "science."[20]

The role of transaction price and other considerations.

While a dissenter's case almost always involves a battle of valuation experts, one factor that can never be ignored is the transaction price—that is, the price that the buyer has actually paid to acquire the business in question. If markets were perfectly efficient, with all parties having perfect knowledge and negotiating at arm's length, we would expect the purchase price to track a company's intrinsic value very closely, if not match it exactly. And even without perfect efficiency, market forces do push transaction prices toward intrinsic or fair value. Courts recognize this, and they often rely heavily on transaction price when assessing fair value.

The Delaware courts, for example, have repeatedly held that "the fact that a transaction price was forged in the crucible of objective market reality (as distinguished from the unavoidably subjective thought process of a valuation expert) is viewed as strong evidence that the price is fair."[21] The apparent objectivity of transaction price has led more than one court to discount the opinions of the parties' experts entirely and rely solely on transaction price when determining the fair value of a company.[22]

Not every deal, however, will lead to a transaction price that approximates fair value. For example, the magic of finance often creates opportunities for "synergy"—that is, where the combination of two companies is more valuable than the sum of its two parts standing alone. Synergy is often a prime motivator in acquisitions, and if a buyer can create synergies by acquiring the target company, it may be willing to pay more than what the target company, standing alone, is worth to its current owners.[23] In that case, the deal might result in a transaction price that is higher than the target's intrinsic value.

Conversely, a company's controlling shareholders might be willing to accept less than fair value for the company as a whole if they can structure the deal so they benefit in some way other than receiving their share of the transaction price (for example, by entering into valuable personal contracts with the buyer). In that case, the deal might result in a transaction price that is lower than the target's

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[20] *See, Matter of Shell Oil Co.*, 607 A.2d 1213, 1121 (Del. 1992)("Valuation is an art rather than a science."); *In re Smurfit–Stone Container Corp. S'holder Litig.*, 2011 WL 2028076, at *24 (Del. Ch. 2011)("[U]ltimately, valuation is an art and not a science.")

[21] *Van de Walle v. Unimation, Inc.*, 1991 WL 29303, at *17 (Del. Ch. 1991).

[22] *E.g., Union Illinois 1995 Investment L.P. v. Union Financial Group, Ltd.*, 847 A.2d 340 (Del. Ch. 2003).

[23] *M.P.M. Enter., Inc. v. Gilbert*, 731 A.2d 790, 797 (Del. 1999).

intrinsic value. In the end, transaction price can be very important evidence of fair value, but only "so long as the process leading to the transaction is a reliable indicator of value and [transaction]-specific value is excluded."[24]

Again, the dissenter's rights statute does not account for transaction price or, for that matter, any other factor that may weigh on the issue of fair value. But, as a practical matter, transaction price looms over every judicial appraisal of fair value. Therefore, from the shareholder's perspective, it isn't sufficient just to assert that the company was worth more than what was paid for it, even if that assertion is supported by a gold-plated expert report. The shareholder must also carry the implicit burden of showing there was some defect in the transaction, such as self-dealing, that resulted in a sale for less than fair value.

Better yet, the dissenter will also prove how the missing value was diverted, in whole or in part, to the controlling shareholders. If the controlling shareholders accomplished this through contracts with the buyer, the dissenter should be prepared to offer expert testimony regarding the true value of the controlling shareholders' promises under the contract. (This may require the dissenter to retain a second expert with expertise in executive compensation or related areas.) Again, none of these elements are literally required by the dissenter's statute. But without this showing, it is hard for even the best expert opinion to prevail over transaction price.

This paper can only scratch the surface of the issues that will confront the litigator in a dissenters' rights case. For understanding valuation in general, *Investment Valuation* by Aswath Damodaran and *Financial Valuation* by James Hitchner are both essential resources. Likewise, *The Lawyer's Business Valuation Handbook* by Shannon Pratt and Alina V. Niculita is useful for understanding how these principles are applied in business disputes.

[24] *Union Illinois*, 847 A.2d at 357.

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