Belk of Spartanburg, S.C. v. Thompson: An Overview and Analysis of the Techniques Employed to Value Minority Interests in Closely Held Corporations in Dissenters' Rights Cases

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BELK OF SPARTANBURG, S.C. v. THOMPSON: AN OVERVIEW AND ANALYSIS OF THE TECHNIQUES EMPLOYED TO VALUE MINORITY INTERESTS IN CLOSELY HELD CORPORATIONS IN DISSENTERS’ RIGHTS CASES

I. INTRODUCTION

Under the South Carolina dissenters’ rights statute, minority shareholders who dissent from certain corporate actions may petition a state court for the “fair value” of their shares.1 However, what constitutes fair value is not clear. What exactly do minority shareholders own when they hold stock in a closely held corporation, and how should the courts properly compensate these shareholders when they seek an appraisal of the fair value of their shares?

As stated by one authority, “Valuation issues pervade the work that legal, financial, and accounting professionals engage in every day, especially when such professionals work with closely held businesses. . . . [I]t is important that professionals . . . possess . . . a rudimentary understanding of valuation of closely held businesses in order to serve their clients properly.”2 In Belk of Spartanburg, S.C. v. Thompson3 the South Carolina Court of Appeals afforded an overview of the valuation methodology employed by South Carolina courts. At the same time, Belk illustrates that there are unanswered questions in South Carolina valuation jurisprudence.

Part II of this Note reviews the South Carolina dissenters’ rights statute, the Belk decision, and cases which preceded and informed Belk’s analysis. Part III describes valuation techniques and suggests how Belk’s analysis could be expanded to provide a more complete explanation of fair value in dissenters’ rights cases.

1. S.C. CODE ANN. § 33-13-101 to -310 (Law. Co-op. 1976 & Supp. 1999). These corporate actions include, inter alia, mergers, share exchanges, and sales or exchanges of all, or substantially all, of the property of the corporation other than in the usual course of business. Id. § 33-13-102(A). The statute also provides that the minority shareholder may dissent from “any corporate action to the extent the articles of incorporation, bylaws, or a resolution of the board of directors provides that voting or nonvoting shareholders are entitled to dissent and obtain payment for their shares.” Id. This broad provision contrasts with the requirement that the shareholder be entitled to vote on the corporate actions discussed in the text of the statute. Thus, unless this provision applies, minority shareholders may dissent only if they are entitled to vote on the corporate action to which they object. Dissenters’ rights are further limited to shares which are not “listed on a national securities exchange or designated as a national market system security.” Id. § 33-13-102(B). Although dissenters’ appraisal rights are controversial, every state now has a provision for such rights. DALE A. OESTERLE, THE LAW OF Mergers AND Acquisitions 72, 75 (West Group ed., 1999).


II. BACKGROUND

A. South Carolina's Dissenters' Rights Statute

Historically, state courts, interpreting strict corporate codes, required unanimous shareholder consent for all extraordinary corporate acts, because such acts materially altered each shareholder’s investment contract with the corporation. This requirement proved burdensome as corporations became more complex, so many state legislatures gradually reduced the default consent requirement to a simple majority of all outstanding shares. To offset the minority shareholders’ loss of the veto power, the legislatures granted them appraisal rights, often referred to as dissenters’ rights.

The tension between majority and minority interests is a financial reality in almost any corporation, and state legislatures have attempted to strike a balance that protects minority shareholders while allowing the controlling shareholders to be entrepreneurial. The purpose of dissenters’ rights statutes is fairness, and these statutes serve “as a check against rampant majority rule.” Therefore, if a fair price is not determined by fair valuation mechanisms, the statutes fail in their purpose and the minority shareholders are “vulnerable to abuse at the hands of the majority.” As the Official Comment to the South Carolina dissenters’ rights statute states, “[T]he majority is given an almost unlimited power to change the nature and shape of the enterprise and the rights of its members. On the other hand, the members who dissent from these changes are given a right to withdraw their investment at a fair value.”

While the historical foundation and purpose of the statute are not difficult to divine, applying the statute is a different matter. The statute 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 to which the dissenter objects . . . unless exclusion would be inequitable.” The shares are to be valued “by techniques that

4. OESTERLE, supra note 1, at 21.
5. Id.
6. Id. at 22; see also S.C. CODE ANN. § 33-13-101 cmt. 1 (Law. Co-op. 1976) (noting the “tension between the desire of corporate leadership to be able to enter new fields, acquire new enterprises, and rearrange investor rights and the desire of investors to adhere to the rights and the risks on the basis of which they invested”).
9. Id.
10. S.C. CODE ANN. § 33-13-101 cmt. 1. The Official Comment also notes that parties should “settle their differences in private negotiations, without resort to judicial appraisal proceedings.” Id. However, minority shareholders are usually relatively powerless, so the statute affords them an appraisal remedy to ensure that they receive a fair price for their shares and are not disenfranchised. Id.
11. Id. § 33-13-101(3).
are accepted generally in the financial community.” Although these vague terms give courts flexibility to consider equitable notions in dissenters’ rights cases, they also deprive the courts of guidance in their attempts to ascertain fair value.

B. Background

Although the appraisal remedy has been available in the United States for well over a century, it has only recently seen a great deal of use. Nevertheless, issues raised in several early cases remain important in modern dissenters’ rights cases. In the Ohio case of Miller v. Canton Motor Coach, Inc., the Ohio Court of Appeals held that a dissenting shareholder was entitled to the “fair cash value” of his stock. The court struggled with the meaning of fair cash value, ultimately concluding that this value was not “fair market value,” but rather the “intrinsic worth of the stock.”

An early South Carolina case, Johnson v. Baldwin, suggests the policy underlying the present-day South Carolina dissenters’ rights statute. The court addressed the tension between majority and minority interests and concluded that the statute “was intended to afford fair and just compensation to the dissenters and at the same time provide a method by which their objections could be fairly composed so as to enable the consolidation to proceed.”

12. Id.
13. As the statute itself points out, the provision “unless exclusion would be inequitable” follows the Delaware Supreme Court’s reasoning in Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983), a seminal valuation case discussed in more detail later. See S.C. CODE ANN. § 33-13-101 cmt. 2. In Weinberger, the court found that the transaction did not involve fair dealing or fair price and crafted a remedy that attempted to “do” equity. Weinberger, 457 A.2d at 711, 714; see also SHANNON P. PRATT, VALUING SMALL BUSINESSES AND PROFESSIONAL PRACTICES 371 (1986) (noting that the Weinberger court demanded that both the value conclusion and appraisal procedures be fair).
14. See, e.g., Wertheimer, supra note 8, at 616 (attributing the recent upsurge in appraisal litigation to post-Weinberger fallout); MELVIA. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 75 (1976) (noting that Ohio had appraisal statutes as early as the 1850s).
16. Id. at 488.
17. Id. at 489. The Miller court cited Manning v. Brandon Corp., 163 S.C. 178, 186, 161 S.E. 405, 408 (1931), an early South Carolina case which stated that “[the appraisal] statute should be construed liberally in favor of the stockholder.” Id. at 488. The Manning court concluded that the minority shareholder had been stripped of his equity position against his wishes, and construed fair value to include the full value of his stock plus costs and attorneys’ fees. Id. at 186, 161 S.E. at 408.
19. Id. at 154, 69 S.E.2d at 591. Another early South Carolina case, Johnson v. Spartanburg County Fair Ass’n, 210 S.C. 56, 41 S.E.2d 599 (1947), explored statutory policy, noting that the majority shareholders have the final decision as to the price at which corporate assets are to be sold, absent fraud or illegality. Id. at 70, 41 S.E.2d at 605. Therefore, the court reasoned that the dissenting shareholders had “a plain and adequate remedy-at-law in the appraisal proceedings to secure the fair value of [their] stock.” Id.
The seminal South Carolina valuation case is Santee Oil Company v. Cox, and most of Belk's valuation analysis is drawn from Santee. Santee states several propositions crucial to South Carolina's modern valuation jurisprudence. For example, Santee states that "'fair value' does not restrict the appraising court to the use of any one method of valuation." Citing Delaware law, the supreme court held that both market value and net asset value, discussed below, are appropriate, non-exclusive measures of valuation. Accordingly, each case is to be decided on its own facts and circumstances, and every financial factor relevant to the value of the corporate property, and ultimately to the value of its stock, is to be considered.

Although Santee constitutes an important road map to determining intrinsic value, the opinion acknowledges that valuation entails subjectivity and judgment. Appraisers and courts must decide how to weigh each of the aforementioned valuation methods as they evaluate a myriad of financial data. Ultimately, of course, the courts often face the task of choosing from among widely varying value figures, each of which is posited by an "expert," and each of which may seem completely plausible under the circumstances. The South Carolina Supreme Court's opinion in Segall v. Shore frankly concedes that valuing the stock of a closely held business is difficult and fact-specific.

C. Belk of Spartanburg, S.C. v. Thompson
In *Belk*, minority shareholder Carolyn Thompson (Thompson) dissented from Belk Department Store of Spartanburg, S.C., Inc.’s (BDS) decision to merge with another Belk Department Store in Clinton, South Carolina. The resulting corporation was named Belk of Spartanburg, Inc. (BOS) after the merger became effective. BDS’s tender of approximately fifteen hundred dollars per share was based on the two most recent known transactions of BDS’s stock, but Thompson felt that her minority interest in this closely held corporation was being undervalued. After the parties’ negotiations failed to produce an agreement, BOS, as required by the statute, petitioned the trial court to determine the fair value of Thompson’s shares. Each side produced numerous experts, and their “proposed valuations ranged widely, from BOS’s expert’s valuation of $1,435.31 per share to the dissenters’ appraisal of $7,930.30 per share.” The trial court’s valuation analysis produced results much closer to the corporation’s estimates than to Thompson’s estimates, and Thompson appealed.

The South Carolina Court of Appeals affirmed the trial court’s valuation. However, the valuation process itself is of more interest than the numbers. According to the *Belk* court, for the purposes of dissenters’ rights cases, “‘fair value’ is defined as ‘intrinsic value.’” In the court’s view, “The trial court must undertake to compute the fair value by establishing the ‘fair market value of the corporate property as an established and going business.’” To establish fair value, three factors are normally considered: “(1) net asset value, (2) market value, and (3) the earnings or investment value of the dissenting stock.” Finally, viewing the facts and circumstances of each case, the court weighs each of these factors “as to their relative bearing upon the ultimate determination of the fair value of the dissenting stock.” This process, explored further in Part III, is known as a *Santee* analysis, deriving its name from the seminal South Carolina Supreme Court case.

Omitted from the *Belk* discussion were minority and marketability discounts. Therefore, although *Belk* reaffirmed South Carolina’s basic valuation methodology in dissenters’ rights cases, its analytical structure is incomplete.

South Carolina case law demonstrates the difficulty encountered when applying technical tests to reach fair value in dissenters’ rights cases. Ultimately, a statutory

32. Id. at 113, 522 S.E.2d at 359.
33. Id. at 114, 522 S.E.2d at 359.
35. Belk, 337 S.C. at 114, 522 S.E.2d at 359-60.
36. Id. at 114-15, 522 S.E.2d at 360.
37. Id. at 115, 522 S.E.2d at 360.
38. Id. at 128, 522 S.E.2d at 367.
39. Id. at 116, 522 S.E.2d at 360 (citing Santee Oil Co. v. Cox, 265 S.C. 270, 273, 217 S.E.2d 789, 791 (1975)).
40. Id. (quoting Santee, 265 S.C. at 273, 217 S.E.2d at 791).
41. See Belk, 337 S.C. at 116, 522 S.E.2d at 361 (citing Santee, 265 S.C. at 274, 217 S.E.2d at 791).
42. Id. (citing Santee, 265 S.C. at 274, 217 S.E.2d at 792).
term as vague as "fair value" begs the question of what is indeed proper compensation for minority interests in closely held corporations.

III. ANALYSIS

The South Carolina rule presently in effect employs three common valuation methods: net asset value, market value, and discounted earnings or investment value. Each type of valuation is assigned a relative weight based on the facts and circumstances of the case, and a share value is thereby derived. This Part considers each of these methods in turn and assesses their feasibility and appropriateness in the context of valuing dissenters' minority interests in closely held corporations.

A. Distinguishing Fair Market Value from Fair Value

Before delving into the methods used to obtain the fair value of the dissenters' stock, it is important to draw a distinction between fair value and fair market value. Fair market value is defined as "the amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts." Fair market value presumes a hypothetical willing buyer and seller dealing at arm's length and does not consider any values which would be ascribed to an investment by a particular buyer or seller. The share price of a publicly traded stock represents its fair market value.

Fair value represents each share's portion of the intrinsic value of a going concern. According to Pratt, an expert in business valuation, fair value is "an excellent example of ambiguous terminology used in the field of commercial appraisal. In order to understand what the expression means, you have to know the context of its use. . . . [I]n most states, fair value is the statutory standard of value applicable in cases of dissenting stockholders' appraisal rights." South Carolina courts have construed fair value to be intrinsic value in the context of dissenters' rights cases. Like fair market value, intrinsic value focuses

45. Id. at 124, 522 S.E.2d at 365.
47. Id.
48. Id. As Pratt points out, fair market value is the "price at which a transaction could be expected to take place under conditions existing at the valuation date." Id.
49. See supra text accompanying note 40.
50. See Pratt et al., supra note 46, at 45; see also Bobbie J. Hollis II, The Unfairness of Applying Lack of Marketability Discounts to Determine Fair Value in Dissenters' Rights Cases, 25 J. CORP. L. 137, 141 (1999) (noting that "[f]air value" is not the same as, or short-hand for, 'fair market value.' "Fair value" carries with it the statutory purpose that shareholders be fairly compensated, which may or may not equate with the market's judgment about the stock's value." (citing Joseph W. Anthony & Karlyn V. Boras, Betrayed, Belittled . . . But Triumphant: Claims of Shareholders in Closely Held Corporations, 22 WM. MITCHELL L. REV. 1173, 1186 (1996))).
on the "perceived characteristics inherent in the investment, not tempered by characteristics peculiar to any one investor. Rather, this value is tempered by how these perceived characteristics are interpreted by one analyst versus another."52 Intrinsic value is, in theory, the true or real worth of a security, not its current market price.53 Various fundamental factors affect the intrinsic value of a security, including the value of the firm's assets, likely future interest and dividends, likely future earnings, and likely future growth rate.54 However, as Pratt readily concedes, it is very difficult to distinguish intrinsic value from fair market value because "the actions of buyers and sellers based on their specific perceptions of intrinsic value eventually lead to the general consensus market value and the constant and dynamic changes in market value over time."55

B. Net Asset Value Method

The net asset value method is the easiest, most inexpensive, and least subjective of the three valuation techniques.56 However, in its purest form, this method is a poor indicator of the closely held corporation's current fair market value.57 To use this method, the appraiser refers to the company's balance sheet to obtain the book values of the assets, deducts the book values of the liabilities, and arrives at the net asset (or equity) value of the company.58

Under Generally Accepted Accounting Principles, assets are carried on the balance sheet at their historical cost or at the lower of their cost or market value.59 When South Carolina courts employ the net asset value method, they should consider following the "adjusted book value" approach. This modified approach revalues the subject entity's assets and liabilities to their current market values and

52. See PRATT ET AL., supra note 46, at 43.
53. Id.
54. Id.
55. Id. at 44. Regardless of the difficulty in distinguishing fair market value from intrinsic value, the Belk court rejected Thompson's attempts to obtain the "fair market value" of her shares. Belk of Spartanburg, S.C. v. Thompson, 337 S.C. 109, 115, 522 S.E.2d 357, 360 (Ct. App. 1999).
56. See SOLOMON & SARET, supra note 2, at 36.
57. Id.
58. Id. Book value is an accounting term, not an appraisal term, and does not represent any standard of value at all. See PRATT, supra note 27, at 17. In effect, assets are placed "on the books" when they are purchased, and thus are carried at their historical cost, subject to any deductions for depreciation. Id. Liabilities are typically carried at face value. Id. As more time lapses from the "booking" of the asset or liability, the relationship between book value and the market value, tenuous from the start, becomes nonexistent. Id. Additionally, there exist many intangible assets, such as goodwill, name recognition, and customer loyalty, none of which is typically valued on a balance sheet. See SOLOMON & SARET, supra note 2, at 37. Perhaps the only redeeming feature of this pure net asset valuation method is that it can be performed expeditiously, and it relies on a fixed book value figure, removing much of the subjectivity inherent in other valuation methods discussed below. Id. at 36.
identifies and accounts for off-balance sheet assets and liabilities. This adjusted approach may be useful if much of the corporation’s value is derived from its assets. However, if the corporation’s value is not in its assets, but in its earnings, the net asset value method should be accorded less weight.

C. Market Value Method

Market value is the second major valuation method considered in South Carolina. The method actually has two forms. The first form is known as the guideline company method (“GCM”). This method is particularly useful when similar corporations are available for comparison. However, if guideline companies cannot be found the courts must rely on previous sales of the closely held corporation’s stock. This second form is not favored because closely held corporations’ stocks are typically infrequently traded, and the sales often occur between related parties.

The steps involved in applying the GCM are not complex, though they do require more time and thought than the net asset value method. In effect, the appraiser selects similarly situated, publicly traded companies (“guideline companies”), and from these companies the appraiser derives “value measures.”

60. See SOLOMON & SARET, supra note 2, at 39. Solomon and Saret suggest that off-balance sheet assets such as internally generated goodwill should be identified for recognition under the adjusted book value method. Id. Additionally, the authors claim that off-balance sheet (contingent) liabilities must be recognized and valued as well. Id. These contingent liabilities include, inter alia, pending litigation claims, warranty claims, tax claims, and contractual claims. Id.

61. See Morrow v. Marktschink, 922 F.Supp. 1093, 1103 (D.S.C. 1995) (stating “[a]s a general rule, more weight is given to asset value than to earnings in an asset holding company such as a real estate business, whereas the reverse is generally true of a manufacturing company or other company producing goods and services” (citing Harry J. Haynsworth, Valuation of Business Interests, 33 MERCER L. REV. 457, 460 (1982))).

62. Morrow, 922 F.Supp. at 1103. The Morrow court concluded that “essentially all of the value of the corporate shares derive[d] from the net asset value of the corporation . . . [and] that the corporation’s net asset value represent[ed] the fair value of the corporation’s stock.” Id.

63. See SOLOMON & SARET, supra note 2, at 56. (“The GCM’s underlying rationale is that numerous public stock transactions on the public markets constitute good evidence from which valuation professionals may derive values of similarly situated nonpublic businesses.”).

64. Id. Obviously, if the selected guideline companies are truly similar to the closely held corporation, this method provides a very direct, market-based indication of the closely held corporation’s stock value. See SHANNON P. PRATT, SELECTING EXPERTS AND EVALUATING EXPERTS’ WORK PRODUCTION 41 (1999) [hereinafter SELECTING EXPERTS] (noting that this method is “[b]ased on public market daily transactions”).


66. Id. at 125, 522 S.E.2d at 365. A sale between related parties is not at “arm’s length.” An arm’s length transaction is one “negotiated by unrelated parties, each acting for his or her own self interest. [T]his type of transaction is the basis for a fair market value determination.” BLACK’S LAW DICTIONARY 71-72 (6th ed. 1991). Therefore, related-party transactions may not accurately reflect the fair market value of the stock.

67. See SOLOMON & SARET, supra note 2, at 56.
These value measures are then applied to the financial data of the company being valued, and the value conclusion is reached.68

Selecting the guideline companies is probably the most challenging step of the process and also the most critical.69 When dealing with a closely held corporation, finding similarly situated public guideline companies can be quite difficult. Failure to find such guideline companies can be fatal to an expert’s analysis.70

However, with careful documentation and assiduous attention to each potential guideline company’s attributes, a diligent valuation expert can often find suitable guideline companies for use in the valuation. The important comparative factors include the following: business or product lines, capital structure, market or geographic region, earnings and dividend-paying capacity, size and position in the industry, credit status, depth of management and personnel experience, nature of competition, and maturity of the business.71 From a practical standpoint, a closer correlation between the guideline and subject companies, along with greater trading volume of the guideline company, will generally require the selection of fewer guideline companies to perform the valuation analysis.72

After selecting suitable guideline companies, the valuation expert develops “valuation measures.”73 These measures are usually predicated upon income statement accounts such as net income before taxes, net sales, or dividends.74 The rationale behind using income statement valuation measures, rather than those based upon balance sheet accounts, is that the income statement reflects a company’s earnings-generating capacity over time and is thus a more stable and reliable indicator of value.75 By contrast, the balance sheet, with its asset and liability accounts, merely “reflect[s] a relationship between value and balance sheet items at a particular point in time.”76 Therefore, value measures based on the balance sheet will be less reliable because the balance sheet is not an averaging of past performance but merely a snapshot of a company’s financial picture at one moment in time.

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68. Id.
69. Id. at 58.
70. See Belk, 337 S.C. at 116-17, 522 S.E.2d at 361.
71. See SOLOMON & SARET, supra note 2, at 59-60. Solomon and Saret also cite the IRS’s Revenue Ruling 59-60, which reemphasizes the need to select guideline corporations engaged in the same or similar lines of business as the subject entity. Id. at 58 (citing Rev. Rul. 59-60, 1959-1 C.B. 237, 242). Additionally, the IRS notes that the guideline corporation’s stock must be actively traded by the public, preferably listed on an exchange, but at the very least traded on the over-the-counter market. Rev. Rul. 59-60, 1959-1 C.B. 237, 242; see also Westreco, Inc. v. Commissioner, 64 T.C.M. 849, 860 (1992) (eviscerating the IRS’s valuation analysis because the guideline companies selected were not comparable to the closely held corporation and noting that this failure tainted the entire valuation).
72. See SOLOMON & SARET, supra note 2, at 60.
73. Id. at 56. Extensive discussion of the development of value measures is beyond the scope of this Note. However, for an excellent discussion of the selection and application of these measures, see id. at 60-66.
74. Id. at 57.
75. Id.
76. Id.
After the valuation measures are chosen, they are applied to the subject company’s financial data.\textsuperscript{77} Although this process sounds simple, it requires adjustments to the financial statements of both the guideline and the subject entity to ensure that the financial data are comparable.\textsuperscript{78} Additionally, assuming that multiple valuation measures have been selected, the valuation professionals must decide how much weight to place on each valuation measure as well as on each guideline company.\textsuperscript{79} Obviously, a great deal of subjectivity and professional judgment enter the evaluation at this juncture. The appraiser may ascribe more weight to a particular company or value measure based merely on the appraiser’s confidence in the comparability of the data.\textsuperscript{80}

A final interesting aspect of the market value method is its relation to minority and marketability discounts, discussed further below. The GCM is based on public market daily transactions, and these transactions reflect the sale of minority, fully marketable interests.\textsuperscript{81} Because publicly traded shares are always minority interests, they have already been discounted by the market from their intrinsic value.\textsuperscript{82} However, since publicly traded minority stocks are almost limitless marketable, and closely held corporations’ minority stock interests are not, some commentators believe that a “discount for lack of marketability . . . should be applied.”\textsuperscript{83} The myriad differences between publicly traded and closely held corporations have prompted certain commentators to claim that the market value method is not appropriate for dissenters’ rights cases.\textsuperscript{84} Regardless of its flaws, this valuation method is firmly established in South Carolina’s jurisprudence.\textsuperscript{85} As shown in the preceding discussion, this method can be extremely valuable if comparability between private and public companies can be established with some reliability, or, to a lesser extent, if a reconstructed market for the closely held stock can be created.

\textbf{D. Earnings/Income Method}

The earnings method has been called “the most important of the three basic approaches to business valuation.”\textsuperscript{86} This approach is bottomed on the proposition

\begin{itemize}
\item \textsuperscript{77} Id. at 56.
\item \textsuperscript{78} See SOLOMON & SARET, supra note 2, at 64. These adjustments may be necessary to reconcile differing accounting methods, and to harmonize the entities’ extraordinary, nonrecurring, and nonoperating items. \textit{Id.}
\item \textsuperscript{79} Id. at 65.
\item \textsuperscript{80} Id.
\item \textsuperscript{81} See SELECTING EXPERTS, supra note 64, at 41.
\item \textsuperscript{82} Id. Assessing a minority discount on the closely held minority stock would in effect “double discount” the stock. Obviously, if only minority interests are traded on public exchanges, the market accounts for and implicitly assesses such a minority discount to those shares, so further devaluing of the closely held minority equity interest is inappropriate. \textit{Id.}
\item \textsuperscript{83} Id.
\item \textsuperscript{84} See, e.g., SOLOMON & SARET, supra note 2, at 57-58 (“The GCM is most valuable when . . . the applicable standard of value is the fair market value standard . . . rather than another standard (for example, fair value for corporate dissenting rights actions) . . . .”).
\item \textsuperscript{85} See Santee Oil Co. v. Cox, 265 S.C. 270, 274, 217 S.E.2d 789, 791 (1975).
\item \textsuperscript{86} Id. at 46.
\end{itemize}
that the value of a share of stock is equal to the “present value of [anticipated] future cash flows.” Future benefits of ownership also accrue to the shareholder in the form of capital appreciation. There are two basic versions of the income method: the capitalized earnings approach and the discounted earnings approach.

The capitalized earnings approach focuses on a single historical measure of investment return. The selected measure is divided by a “capitalization rate that reflects both the risk and the expected rate of growth” of the estimated future cash flows. The capitalized approach assumes that past results will continue into the future and therefore relies on these past results as indicative of stock value.

Gathering the data to conduct a capitalized approach is not particularly difficult. The measure of investment return may be as simple as net cash flow or net income from the prior year; however, the averaging of several years’ worth of financial data produces a more reliable and stable indicator of historical trends that can be expected to continue into the future.

The difficulty in the capitalization method lies in the selection of an appropriate capitalization rate. As mentioned above, this rate should reflect both the risk and the rate of growth of the investment. This rate effectively encompasses growth expected beyond the current time, as the data to which it is applied reflects only a current return. The risk of an investment may be thought of as “the certainty (or uncertainty) as to the realization of the expected returns on the investment, both as to amounts and timing.” The capitalization rate effectively “equals the rate of return required to induce investors to commit available funds to the subject investment, taking into consideration its risk level.”

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87. Id.
88. Id. at 48. The Belk court, citing Bell v. Kirby Lumber Corp., 413 A.2d 137, 143 (Del. 1980), noted that “[n]ormally the demonstrated capacity of the corporation to earn money and pay dividends is very important in determining the value of its stock.” Belk of Spartanburg, S.C. v. Thompson, 337 S.C. 109, 121, 522 S.E.2d 357, 363 (Ct. App. 1999).
89. See SELECTING EXPERTS, supra note 64, at 38.
90. Id. Typically, the prior year’s net cash flow or net income is the measure of return used. Id.
91. Id. (emphasis omitted).
92. See SOLOMON & SARET, supra note 2, at 47.
93. See Adams v. R.C. Williams & Co. 158 A.2d 797 (Del. Ch. 1960). The Adams court noted that “[a]n important purpose behind the practice of taking the average of several years [sic] earnings for the purpose of capitalizing earnings is to balance extraordinary profits and losses.” Id. The court therefore rejected the appraiser’s determination of “average” earnings for capitalization purposes because he had “limited himself to a two year period.” Id.
94. See supra text accompanying note 91.
95. See SELECTING EXPERTS, supra note 64, at 39.
96. Id. at 38 (emphasis omitted).
97. See SOLOMON & SARET, supra note 2, at 49. Although Solomon and Sare do not explicitly discuss the capitalization method in their rate of return analysis, much of their analysis devoted to the discount method is applicable, given that both the capitalized earnings and discounted earnings methods require determination of a rate of return to calculate present value. See SELECTING EXPERTS, supra note 64, at 38-39. Additionally, the capitalization rate “equals the discount rate less the growth rate.” Id. at 39. The only effective difference between the two rates is that the capitalization rate assumes constant future growth, thus obviating the need to include any future growth rate in its formula, whereas the discount rate does not assume that past results will continue into the future. See SOLOMON & SARET,
investment is the product of two components: the risk-free rate and the risk premium.\(^9\) By aggregating these two components, investors can realistically assess the chances that they will realize their expected future returns. The riskier the investment, the lower the value that will be assigned to the stock.\(^9\)

To reiterate, the discounted earnings approach is used when past returns are not expected to continue into the future.\(^10\) Unlike the capitalization rate, which reflects only growth beyond the current time, the discount rate reflects the "total rate of return that the investor expects to realize over the life of the investment."\(^10\) The discounted approach is increasingly being approved by the courts, partly because this approach is being employed more and more often by practitioners and also because the methodology has been clearly laid out in reference sources.\(^1\) Although the discounted earnings approach is gaining currency, this method requires courts to take a leap of faith. As opposed to viewing objectively verifiable historical data, courts are forced to accept experts' testimony that market conditions will change and these experts' educated guesses as to how they will change. Obviously, corporations that derive most of their value from asset holdings are not likely to be valued under this income-based approach.\(^1\)

\(^{supra}\) note 2, at 47. Although extensive risk analysis is beyond the scope of this Note, Solomon and Saret conclude that the rate of return (capitalization or discount rate) will equal the cost of capital, or, in stock valuation cases, the cost of equity. \(id\). at 49.

\(^9\) See SOLomon & Saret, \(supra\) note 2, at 49. The authors discuss two prevalent financial models for estimating risk, the capital asset pricing model (CAPM) and the arbitrage pricing model (APM). \(id\). at 52-56. An extensive study of these models is unnecessary for the purposes of this Note, but it is important to recognize that each method uses a slightly different approach to evaluate the components of risk. The risk-free rate "equals the rate of return on investments that are free of default risk, such as U.S. Treasury bonds." \(id\). at 50. This rate effectively compensates investors for inflation, and for renting their money to the corporation. \(id\). "The risk premium is the additional rate of return that investors demand to induce them to invest in investments in which there is the possibility of default." \(id\). For example, corporate stock and non-U.S. Treasury bonds both involve a risk of default. \(id\). As a general rule, smaller corporations have higher rates of return concomitant with the associated higher risk of default. \(id\). at 51.

\(^9\) An illustrative example is useful here. If a stock is assessed as having a capitalization rate of twenty percent, next year's expected returns will be divided by 1.20, the next year's returns will be divided by (1.20)\(^2\), and so forth, for whatever period the appraiser chooses (linked to how long the investor plans to hold his stock). The less risky stock may only be assigned a capitalization rate of fifteen percent, and thus its expected returns will be divided by 1.15, then, in the following year, by (1.15)\(^2\), and so forth. As is obvious from this simple example, the discount/capitalization rate will increase at an increasing rate for the riskier investment; therefore, the present value of the riskier investment will be significantly lower than that of the less risky investment. \(id\). at 47.

\(^1\) See \(supra\) note 97.

\(^10\) Selecting Experts, \(supra\) note 64, at 38 (emphasis omitted).

\(^10\) \(id\). at 39. Pratt cites a Delaware case calling the discounted approach "increasingly, the method of choice in this court." Grimes v. Vitalink Communications Corp., No. 12334, 1997 WL 538676, at *1 (Del. Ch. 1997).

E. Application of the Three Valuation Methods in Belk

The Belk court weighted the net asset value method as 60% of the closely held corporation's value, a far greater weight than the discounted earnings or market methods of value were accorded.104 Belk suggested that the net asset value method was particularly appropriate because the corporation to be valued had recently undergone major renovation to one of its stores.105 "Obviously, BDS was using more than an average amount of its assets to expand and improve its business opportunities. This investment of course was not reflected in earnings at the time of the merger, . . . [but] the directors and shareholders . . . [testified that], at long range, it would be profitable."106 In other words, the renovation was "essential to the ability of BOS/BDS to eventually generate earnings and pay dividends."107

Interestingly, the Belk analysis ignored the fact that a minority interest was being valued within the context of this method. As Pratt succinctly states, "The [net asset value] approach tends to be used when valuing a controlling interest, since a minority interest normally would have no access to or control over the assets. If a minority interest is being valued using the asset approach, it may be appropriate to apply a minority interest and/or marketability discount."108 As discussed later, discounts are a controversial issue in dissenters' rights cases, yet the Belk court chose not to address the issue at all.109

The court assigned a "weight of only 25%" to the market value method.110 The appraisal report given by the dissenters' expert concerning the guideline company method was discounted in part because the expert testified that "'[t]here were significant differences among [sic] the guideline [public] companies and BOS in terms of capital structure, size, and growth rates in revenues and profits.'"111 The expert admitted in his testimony that ownership in the closely held Belk corporation was "'clearly and significantly different from owning stock in one of those large traded companies.'"112 This appraisal testimony clearly involved extensive guesswork and assumptions to the extent that the court felt uncomfortable using this testimony in valuing the closely held corporation.113

105. Id. at 125, 522 S.E.2d at 365.
106. Id. at 125-26, 522 S.E.2d at 366.
107. Id. at 126, 522 S.E.2d at 366.
108. SELECTING EXPERTS, supra note 64, at 44.
110. Belk, 337 S.C. at 125, 522 S.E.2d at 365.
111. Id. at 120, 522 S.E.2d at 363.
112. Id.
113. Id. at 121, 522 S.E.2d at 363. The appraiser acknowledged that "there's great difficulty in even using this method. . . . [B]ut I went about it anyway and derived certain multiples and then adjusted them . . . based on my judgment, for the fact that we're dealing with a hugely different situation here." Id. at 120, 522 S.E.2d at 363.
The court noted that "[t]he weight to be given market value is related to the nature and extent of the market in the stock and how fairly it reflects the judgment of informed buyers and sellers."\textsuperscript{114} Clearly, this closely held corporation had no ready market,\textsuperscript{115} but Santee dictates that "if there is no reliable established market value for the shares a reconstructed market, if one can be made, must be given consideration."\textsuperscript{116} Thus, although it expressed discomfort at relying on a "mere three trades," the Belk court reconstructed a market for the closely held corporation's stock based on three recent stock sales.\textsuperscript{117} However, based on the stock's infrequent trading, the market value method was not weighted very heavily.\textsuperscript{118}

The opinion illustrates the difficulty of applying the market value method to closely held corporations. Although many commentators draw no distinction between the guideline company method and the method which relies on earlier trades of the closely held stock,\textsuperscript{119} Belk demonstrates that they are not synonymous. Clearly, the GCM is preferable because it produces a direct market-based indication of stock value, but if comparable guideline companies cannot be located, South Carolina courts will attempt to reconstruct a market for the closely held entity's stock.\textsuperscript{120} In reconstructing this private market, the courts must diligently examine the relevant stock sales to ensure that they have been fairly negotiated.\textsuperscript{121}

The Belk court weighted the earnings method least, as only fifteen percent of the stock's value.\textsuperscript{122} It preferred the capitalized approach over the discounted approach because "[p]ast experience represented by the actual figures are [sic] of prime importance."\textsuperscript{123} Thompson's appraiser attempted to sway the Belk court to adopt the discounted approach by arguing that the use of historical cash flows was inappropriate due to ""changing market conditions in the BOS trade area.""\textsuperscript{124} The appraiser, however, "used a rate of return based on market information for the large chain department stores, . . . [adjusting] this rate 'for the small size and company-specific risks associated with BOS'" as a closely held corporation.\textsuperscript{125} Based on uncertain market conditions, and on the appraiser's "total dependence on

\textsuperscript{114} Id. at 124, 522 S.E.2d at 365 (quoting In re Tudor City Fifth Unit, Inc., 232 N.Y.S.2d 758, 760 (1962), aff'd 193 N.E.2d 222, 222 (1963)).

\textsuperscript{115} As the court noted, all of the stores in the Belk organization are owned by closely held corporations. Id.


\textsuperscript{117} Belk, 337 S.C. at 125, 522 S.E.2d at 365. Note that these stock sales were made among the closely held stockholders, and were not public market trades.

\textsuperscript{118} Id. The court was willing to rely on three trades because the closely held stock was traded very infrequently, and the Santee court relied on only one trade in its valuation. Id.

\textsuperscript{119} See, e.g., SOLOMON & SARET, supra note 2, at 56 (discussing only the guideline company method and ignoring market reconstruction based on earlier trades of the closely held stock).

\textsuperscript{120} See supra note 116 and accompanying text.

\textsuperscript{121} See supra note 66 and accompanying text.

\textsuperscript{122} Belk, 337 S.C. at 122, 522 S.E.2d at 364.

\textsuperscript{123} Id. (quoting Adams v. R.C. Williams & Co., 158 A.2d 797, 800 (Del. Ch. 1960)).

\textsuperscript{124} Id. at 121, 522 S.E.2d at 363.

\textsuperscript{125} Id.
projections," the Belk court rejected his discounted earnings approach.\textsuperscript{126} Simply put, his methodology was too undependable to be palatable to the court.\textsuperscript{127}

F. Minority and Marketability Discounts

The Belk court ignored minority and marketability discounts, offering no guidance on the issue in dissenters’ rights cases. The debate over whether or not to include such discounts is far from decided, and different states approach this issue very dissimilarly.\textsuperscript{128} In order to evaluate these discounts, it is important to understand what they represent.

A minority discount accounts for the lack of control inherent in minority investments. In a closely held corporation, a control owner enjoys many rights and powers.\textsuperscript{129} These prerogatives include the following: the power to appoint management; determine management compensation; acquire or liquidate assets; liquidate, dissolve, sell-out, or recapitalize the company; declare and pay dividends; make acquisitions; and change the articles of incorporation or bylaws.\textsuperscript{130} Not surprisingly, this discount is often referred to as a non-control discount, and controlling shareholders are often granted a control premium when they sell their controlling interests.\textsuperscript{131}

Several rationales underpin the minority discount, including "(1) self-dealing opportunities; (2) reduction of investment risk due to superior information and control over the entity’s actions; and (3) control over the distribution of the entity’s cash flow to its owners."\textsuperscript{132} The presence of self-dealing opportunities is the most important of the three rationales supporting the application of a minority discount.

\textsuperscript{126} Id. at 122, 522 S.E.2d at 364.

\textsuperscript{127} Id.

\textsuperscript{128} See Christopher Vaeth, Annotation, Propriety of Applying Minority Discount to Value of Shares Purchased by Corporation or Its Shareholders From Minority Shareholders, 13 A.L.R. 5th 840, 863 (1993). Vaeth compiles various dissenters’ rights (and other) cases, some of which reject the application of discounts, and others of which conclude that such application is a matter of discretion for the court. In Cavalier Oil. Corp. v. Hartnett, 564 A.2d 1137, 1144 (Del. 1989), an important Delaware case, the court held that Delaware’s dissenters’ rights statute was designed to value the corporation itself, rather than a specific fraction of the corporation’s shares existing in the hands of a particular shareholder. Id. Thus, the dissenters’ equity interests were valued based solely on their proportionate share of the company’s stock after the valuation had occurred at the corporate level, and no further discounts needed to be applied at the shareholder level. Id.; see also Tri-Continental Corp. v. Battye, 74 A.2d 71, 76 (Del. Ch. 1950) (holding that any further discount at the shareholder level would punish the shareholder, treating him as if he had sold his stock, subject to the minority discount, in the open market; although the minority discount was upheld at the corporate level, the appraisal process assumed that the dissenting shareholder would have been willing to maintain his investment position had the merger not occurred, rather than reconstructing a pro forma sale). For a case allowing a minority discount, see Atlantic States Constr., Inc. v. Beavers, 314 S.E.2d 245, 251 (Ga. Ct. App. 1984) (holding that a “minority interest” factor can be considered at the individual stockholder level when relevant to the fair value of the dissentor’s stock).

\textsuperscript{129} SELECTING EXPERTS, supra note 64, at 47.

\textsuperscript{130} Id.

\textsuperscript{131} SOLOMON & SARET, supra note 2, at 106-07.

\textsuperscript{132} Id. at 109.
in dissenters’ rights cases. A controlling shareholder “may cause the entity to do business with other entities that the owner owns or controls, with the owner himself, or with his or her family members.”

However, these opportunities are often constrained by the majority shareholder’s duty of loyalty to minority interests, as well as by governmental regulations and the financial condition of the business.

Reduction of investment risks through superior information and control may manifest itself in insider trading, managerial changes to improve performance, or modification of the corporation’s bylaws or articles of incorporation. However, strict insider trading laws often weaken the controlling shareholder’s advantage under this theory.

The third theory supporting a minority discount concerns the majority shareholder’s control over the entity’s cash flow. By exercising this control, majority shareholders may distribute dividends to themselves, or they may steer cash to themselves by forcing the entity to do business with them. However, as with the other two theories, state law and contractual provisions may limit the controlling shareholder’s power to direct the corporation’s assets in this manner.

The minority discount analysis does not exist in a vacuum. Such analysis varies based on the applicable valuation standard. In dissenters’ rights cases, where the “fair value” standard generally applies, “planners must look at precedential case law under the applicable state statute when conducting the control analysis.”

Many commentators believe that minority discounts in the context of dissenters’ rights cases are inappropriate. “[M]ost jurisdictions have concluded that a dissenting shareholder is entitled to a proportionate share in the value of the corporation as a whole. This standard accords with the minority shareholder protection rationale of the appraisal remedy.” Although minority discounts have a fairly strong theoretical underpinning, it appears that, in practice, they are infrequently applied in dissenters’ rights cases.

Lack-of-marketability discounts reflect the lack of a ready market in which owners of closely held corporations can sell their stock. Put simply, investors prefer liquid assets, not only because they can quickly obtain cash for their interests, but also because transaction costs are minimal and the realization of net proceeds

133. Id.
134. Id. at 110.
135. Id. at 111.
136. Id.
137. See SOLOMON & SARET, supra note 2, at 111.
138. Id. at 112.
139. Id. at 112-13.
140. Id. at 113.
141. See, e.g., Wertheimer, supra note 8, at 649 (stating that “dissenting shareholders should be entitled to receive a pro rata share of the value of the corporation as a whole, rather than the value of their minority interest; dissenting shares should not be subject to a minority discount; and a market price based valuation should receive an upward adjustment to eliminate the minority discount inherent therein”).
142. Id. at 654. As stated above, this proportionate share in the total value of the going concern is the stock’s intrinsic value. See supra notes 39-40 and accompanying text.
143. See SOLOMON & SARET, supra note 2, at 140.
is a practical certainty. A holder of publicly traded stock can almost immediately liquidate it, usually at an amount that is ascertainable before the sale. By contrast, a minority holder of closely held stock must search for a buyer, then negotiate the terms of sale. Minority shareholders also face a daunting legal hurdle in that they cannot sell their stock to the public without either registering the transaction with federal and state securities regulators or qualifying for an exemption from registration.

Should these discounts be applied in dissenters’ rights cases? Although tax court decisions routinely uphold such discounts, these cases seek fair market value under a “willing seller, willing buyer methodology.” By contrast, dissenters’ rights statutes involve forced buy-outs and seek the fair value of the “squeezed-out” minority interest. Accordingly, the importation of valuation analysis from tax cases to appraisal and dissenters’ actions is fraught with peril and seems logically flawed. As noted above, most jurisdictions have rejected discounts in valuing minority stockholders’ shares. As one commentator opines, “minority shareholders are no longer helpless in the face of majority misconduct. The specter of being ‘locked-in’ but frozen out is being relegated to history.” This commentator concludes that the majority of courts are correct in rejecting “minority and liquidity discounts that can have a dramatic and devastating impact on the value of minority interests.”

Based on the overall import of the term “fair value,” it appears that the courts that have considered and rejected the idea of applying minority and marketability discounts have been correct. The very nature of the term “dissenter” implies that certain parties are being compelled into some act against their wishes—here, to some corporate action to which they object. Given the huge power held by the

144. Id.
145. Id.
146. Id.
147. Id. at 141.
148. See, e.g., Estate of Simplot v. Commissioner, 112 T.C. 130, 153-54 (1999) (holding that “in valuing stock in closely held corporations, discounts are usually warranted . . . because a ready market for shares in the corporations does not exist”).
150. Id. at 480.
151. See id. Murdock argues that discounts have been employed as part of a traditionally conservative approach to valuation from a tax perspective, but that they are inappropriate in dissenters’ rights cases. Id. at 479-80. In addition to the differing value measures, “[i]n the tax situation, it is the levying of a tax that mandates the sale” whereas in the dissenters’ rights context, “it is the conduct of those in control [the majority interest] that forces the sale.” Id. at 480. In the latter situation, the holder “realize[s] the value of the shares at a time the holder deems most propitious,” while in the former, this choice does not exist. Id. Additionally, the minority shareholder loses from a high valuation in tax cases but loses from a low valuation in dissenters’ rights cases. Id. These differences lead Murdock to the conclusion that tax valuation theory should not be imported into the dissenters’ rights context. Id.
152. See supra text accompanying notes 141-42.
153. Murdock, supra note 149, at 480-81.
154. Id. at 484.
155. Id. at 489.
majority interest to control a closely held corporation, it seems that minority shareholders should be compensated fully for their shares, even at the risk of occasional over-compensation.\textsuperscript{156} This risk is preferable to a situation where dissenting shareholders are forced to choose among two evils, either consenting to an act with which they disagree or dissenting from the act and receiving an unfairly low value for their shares.\textsuperscript{157}

IV. CONCLUSION

Courts and commentators have been faced with flexible but vague statutory directives in the area of dissenters’ rights. Ultimately, fairness must be decided on the facts and circumstances peculiar to each case. Despite the fact-specific nature of valuation analysis, understanding the set of financial rights and obligations that accompanies stock ownership aids in the valuation process.

Minority shareholders’ rights must not be trampled by the power of a dominating majority. At the same time, the majority’s right to engage in entrepreneurial pursuits must not be thwarted by unreasonable nuisance suits and over-regulation. As with most legal issues, a careful balance must be struck. The dissenters’ rights statute can be an excellent tool if employed properly to strike this delicate balance. However, if applied improperly, the statute may work onerous injustices upon either the majority or the minority shareholder. Understanding the various financial forces at play in the context of valuing minority interests in closely held corporations is conducive to an informed application of the dissenters’ rights statute, and this understanding will help lawyers and judges reach the goal of full and fair compensation.

\textit{Joshua R. Williams}

\textsuperscript{156} See Hollis, \textit{supra} note 50, at 141-42. Hollis argues that “[i]n the case of a non-publicly traded company, the market value should not be a factor in establishing the fair value of the company.” \textit{Id.} at 142. Obviously, if market value is not a component of fair value, imposing a lack of marketability discount on the minority shareholders’ interests is unfair and “grant[s] the majority an unfair windfall.” \textit{Id.} Hollis ultimately concludes that the purpose of the dissenters’ rights statutes is full compensation and thus believes “[d]iscounts by definition will only take what rightfully belongs to the dissenting shareholder, and as such, they are intrinsically unfair.” \textit{Id.} at 160.

\textsuperscript{157} As Murdock points out, “statutory provisions have been enacted for the benefit of minority shareholders and . . . minority shareholders ought not to be punished in the valuation process.” \textit{Murdock, supra} note 149, at 484 (citations omitted).