LEGAL brief

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The Problem of the Minority Discount

In 1990, John James owned a small manufacturing company. John had two employees and was the company's CEO, CFO, head of sales, floor supervisor and chief mechanic. Business was good, but John was tantalized by the prospect of how much better it could be if he had the capital to expand.

Enter David Darwin, John's friend and dentist. David had discretionary cash and was looking for an investment. Together, the two men decided to incorporate the business. Each put up an equal amount of cash, and John also contributed all of his existing business assets. In exchange, John received 70 percent of the shares of the new corporation, while David received 30 percent.

Fast-forward 10 years. The company is doing well. Unfortunately, significant differences have arisen between the two owners. John, who has been running the company, sees nothing but big things in the future and wants to keep growing the business. Moreover, John is resentful of David, whose investment has grown exponentially as a result of John's hard work and who now resists John's efforts to reinvest in the company. Both men would like to see David's position bought out, but they can't agree on a price.

John decides to use his controlling shares to force David out of the company in a procedure known as a cash-out merger. While the procedure allows John to set the sale price, the law also allows David to contest the sale price and obtain an independent appraisal. Here, the battle is joined in earnest.

The corporate laws of most states, Pennsylvania among them, provide that minority shareholders like David are entitled to "payment of the fair value of his shares." The procedure for defining "fair value" varies, but generally, one or both parties apply to the local court seeking an appraisal. The judge often assigns a neutral expert in business valuation to review the positions of the participants and make recommendations to the judge, who then assigns a "fair value" to the minority shares.

Naturally, there are many issues that arise when a minority shareholder seeks this appraisal remedy. For example, where the majority shareholder is also an employee, as in John's case, has the company overpaid John, and should the company's value be adjusted accordingly? However, no issue is more prevalent — and no question is more unsettled — than whether the court should apply a minority discount.

What is a Minority Discount?

A minority discount is a downward adjustment in the value of shares in a corporation, reflecting the risks associated with a minority position. Consider a company for which a willing buyer would pay $1 million if buying every share of stock. Would the same buyer pay $300,000 for only 30-percent ownership? Probably not, because the 30-percent buyer does not get the benefits of managerial control but does assume the risks, including cash-out mergers, of a minority position. Thus, some argue that the open market forces a discount on minority shareholders and, therefore, the appraisal remedy ought to, as well.

Why Do Minority Discounts Matter?

Several courts have approved discounts of up to 35 percent, and there are studies suggesting that discounts of up to 80 percent may be appropriate. Therefore, the use or nonuse of discounts can dramatically alter the value assigned to minority shares in an appraisal.

What's All the Hubbub?

If the market imposes a discount on minority shares, shouldn't the appraisal process also impose the same discount? In other words, why should a minority shareholder be entitled to receive more in the appraisal process than the minority shareholder could get if the shares were sold on the open market?

One rationale offered is that shareholders expect that each share of stock has an equal value at the time of investment, and therefore, allowing the controlling shareholder to "freeze out" a minority shareholder at a discount would constitute unfair surprise. Unfortunately, the converse of this argument is just as appealing. Specifically, minority shareholders should expect to get less than the controlling shareholder. Hence, failure to apply a minority discount unfairly surprises the controlling shareholder.

In fact, virtually every rationale offered in support of imposing minority discounts in the appraisal process can be inverted to support the contrary view. The net effect of this lack of clarity has been inconsistent rulings from courts of various jurisdictions and even within a given jurisdiction.

In Delaware, for example, the state's highest court sought to end the confusion by declaring that no minority discount was to be applied. Instead, the court said that the owner of, say, 30 percent of a corporation's stock would receive 30 percent of the total value of the business. Unfortunately, valuation methodologies often rely on comparative market data and thereby build in either minority discounts or a related but different concept known as control premium. Therefore, even in Delaware, minority discounts continue to be an issue in appraisal disputes.

Conclusion

The law relating to minority discounts in appraisal disputes continues to be in a state of flux. Because the application (or lack thereof) of the minority discount may dramatically alter the fortunes of the participants in the appraisal process, and because neither side can reliably predict how or if the discount will be applied, it is in the interest of both majority and minority shareholders to agree in advance on how shares will be valued. Mechanisms for effectuating such an agreement are available from the time of investment up to and including the time the appraisal remedy is invoked. For those who are unable to reach an agreement, their future almost certainly includes several furious rounds of legal wrangling, followed by an uncertain and potentially unpleasant outcome.

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