Oppressive Shareholder Value Slashed by New Jersey Court

In a recent decision in New Jersey Superior Court1 involving cross claims of shareholder oppression pursuant to N.J.S.A. §14A:12-7, the Court found it appropriate to apply a marketability discount to the value of the privately-held company stock at issue in determining the buyout price to the oppressive shareholder. As New Jersey is typically a "Fair Value" jurisdiction, marketability discounts are applied only under what is found to be "extraordinary circumstances," such that failure to do so would unjustly enrich the oppressing shareholder or otherwise fail to adequately compensate the prevailing party. The circumstances in Parker v. Parker were found to be extraordinary, and a marketability discount of 25% was applied to the determined "Fair Value" of the enterprise. We review the Opinion and provide our thoughts on the valuation issues.

The Court here acknowledges that the valuation of a privately-held company is based on the set of facts and circumstances unique to the subject entity, and, that valuation methods which are generally recognized within the financial community are applicable in a courtroom. We first review the standards of Fair Value and Fair Market Value. Fair Market Value is defined by the IRS as the price at which the company in question would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.[2] Fair Value is similar to Fair Market Value, however, it does not typically include the application of discounts for minority interest and lack of marketability. Fair Value is most commonly used in determining the value of an enterprise in commercial and matrimonial litigation in New Jersey. However, since the New Jersey Supreme Court decided *Balsamides v. Protameen*, 160 N.J. 352 (1999), along with its companion case, *Lawson Mardon Wheaton, Inc. v. Smith*, 160 N.J. 338 (1999) (dealing with minority oppression),

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[1] *Parker v. Parker*, 2016 N.J. Super Unpub. LEXIS 2720 (Dec. 22, 2016).
[2] Treasury Regulations 20.2031-1(b) and 25.2512; Rev. Rul. 59-60, 1959-1 CB 237.

the case has become a statewide, if not nationally recognized, seminal decision concerning business valuation and the applicability of minority and marketability discounts in oppressed shareholder cases.

In *Lawson Mardon Wheaton, Inc. v. Smith*, the Court held that there should be no marketability or minority interest discounts in determining the "fair value" of appraised shares in a dissenting shareholder action, and that such a discount would prevent dissenting shareholders from realizing the full value of their shares. However, the factors at play in *Parker v. Parker* are distinctly different. The Court in *Parker* found that the oppressed shareholder is the operative *purchaser* of the subject entity shares from the oppressive shareholder. To wit, the failure to apply a discount would unjustly enrich the oppressor.

To summarize the facts of the case, brothers Richard and Steven Parker each ran florist businesses in which the other was a 50% owner. Richard's business, Parker Interior Plantscapes ("PIP"), designs and produces interior landscapes in commercial settings. Steven's business, Parker Wholesale Florists ("PWF"), is a wholesale plant business and garden center. Both businesses operated out of the same offices and shared certain office expenses, yet each brother exclusively managed their own businesses. PIP was successful and growing, while PWF operated at a loss during the prior 20 years and routinely required injections of cash from PIP to keep it afloat. For various reasons, the Court determined that Richard was the oppressed shareholder, and Steven was required to sell his 50% stake in PIP to his brother. Both parties submitted competing expert reports, with widely divergent conclusions. Their respective analyses are summarized below.

<u>Plaintiff's Expert's Analysis</u>

- The Income Capitalization methodology was used.
- The expert adjusted historical (2009 – 2013) pre-tax income ("EBT") for: reasonable compensation, automobile expenses, life insurance, and meals and entertainment expenses. His equal-weighted average annual EBT was determined to be $414,778. Then he tax effected EBT at 33%.
- The expert's discount rate, using the build-up method ("BUM") was 22.3%, and the long-term growth rate was 1.5%, thus the capitalization rate was 20.8%.

- This would have resulted in Fair Value of $1.356 million, or $678,000 for a 50% stake. However, the expert applied a 15% minority discount and 25% marketability discount, arriving at Fair Market Value of $432,225.

Defendant's Expert's Analysis

- The Net Asset Value ("NAV") and Discounted Cash Flow ("DCF") methods were used.[3]
- The expert projected free cash flow during a forecast period (2013 – 2019) and calculated terminal value using the Gordon Growth Model. The projections were based on historical margins with certain adjustments, including: legal expenses and reasonable compensation.
- The expert's discount rate, using the build-up method ("BUM") was 19.67%, and the long-term growth rate was 2.0%, thus the capitalization rate was 17.67%.
- This resulted in Fair Value of $1.789 million, and no discounts were applied. Thus, 50% of the shares were worth $894,500.

Ultimately the Court adopted Plaintiff's Expert's valuation of $1.356 million for a number of reasons. First, the Court reasoned that future cash flow projections were unnecessary when historical financial data existed. In addition, the forward-looking projections did not take into account the declining revenue from a particular line of business at PIP. The Court also noted that Defendant's application of the NAV methodology was criticized as inappropriate in the context of a shareholder buyout, and would not reflect the costs that would be incurred in a liquidation process. Finally, the Court found that an "extraordinary circumstance" existed by way of Steven's "wrongful acts" against his brother, and "In cases where the oppressing shareholder instigates the problems, as in this case, fairness dictates that the oppressing shareholder should not benefit at the expense of the oppressed." Where the Court departed from Plaintiff's Expert was in rejecting a minority interest discount (15%) and applying only a

[3] Defendant's expert submitted two reports. In the original report, the DCF value was determined to be $4.887 million and the NAV value $3.15 million. The original report contemplated significant sales from a contract with DreamWorks that was in its nascent stage at the time of the valuation. The second report removed these projected sales and adjusted company-specific risk downward from 7.5% to 3% to reflect that the potentially risky contract was not included in the valuation. The NAV value did not change in the second report, but the DCF value was reduced to $1.789 million.

marketability discount (25%) to the 50% stake worth $778,000[4]. Defendant therefore must sell his shares to the Plaintiff for the sum of $583,500.

Of most interest, to litigators and valuation experts is the choice of utilizing historical data as opposed to making forward-looking projections. At its most basic, financial valuation doctrine tell us that the value of an enterprise today always equals the future cash flows generated by that enterprise discounted at the opportunity cost of capital.[5] Yet, as we all know, the devil is in the details, and forward projections are only as reliable as the underlying facts and assumptions. It seems here that there were several factors in play in adopting Plaintiff's expert's valuation including considerable uncertainty with regard to the projected future cash flows. PIP's untested contract with DreamWorks was newly penned as of the valuation date, and the prospect of a potential decline in PIP's high-margin Atlantic City business loomed. Perhaps the judge was uncomfortable with the speculative nature of the projections – and Defendant's Expert may have been as well, hence the last minute revision which more than halved his value.

Valuation experts should be mindful of a few of the takeaways, as follows:

- <u>Stick to the Facts (and Circumstances)</u> – Rely on client specific, industry and macroeconomic information as it existed on or about the valuation date;
- <u>Know the Purpose</u> - Apply standard valuation methods, as appropriate to the entity *and purpose* of the valuation; and
- <u>Know Your Limits</u> - Avoid making any *legal* determination as to whether minority and marketability discounts should be applied.

Ultimately, the Court's finding of oppression on the part of the selling shareholder guided the adoption of Plaintiff's valuation methodology and the application of a marketability discount.

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[4] By our calculation, one half of $1.356 million is $678,000, not $778,000. Discounted at 25%, Defendant's shares are worth $508,500, and not $583,500. Without seeing the actual work papers used to derive the award, we are reluctant to term this an error.

[5] See, e.g.: Brealey, Richard A., Myers, Stewart C., and Allen, Franklin, <u>Principles of Corporate Finance</u>, (9th, 2008), Ch.5.

For More Information, Contact:

Cynthia L. Jones, CFA
cjones@mpival.com
(609) 955-5722

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