Oppression of Minority Shareholders and Court Ordered Fair Value

By Thornwell F. Sowell and George W. DuRant

The leading treatise on shareholder disputes for years has been O'Neal and Thompson's *Oppression of Minority Shareholders and LLC Members*. In the preface to the 2007 Revised Second Edition of that work, the authors note that "[m]ost American lawyers do not realize the tremendous amount of litigation in this country arising out of shareholder disputes." 1 F. Hodge O'Neal & Robert B. Thompson, *Oppression of Minority Shareholders and LLC Members* iii (Rev. 2d ed. 2007). The authors go on to note that since the publication of the first edition of their treatise, "the volume of litigation grounded on minority shareholder oppression—actual, fancied or fabricated—has grown enormously, and the flood of litigation has been pronounced in both federal and state courts, with an especially large number of suits challenging the validity of 'cash-out' mergers." *Id*. They note, however, that "[t]he reports of judicial decisions involving shareholder disputes are poorly digested and are not satisfactorily or uniformly 'keyed' or classified in the research aids. Although a considerable amount of literature on oppression of minority shareholders exists in Britain and the Commonwealth countries, in this country legal writing on shareholder oppression and on 'corporate dirty tricks,' such as 'squeeze-outs' of minority shareholders, is fragmentary and scattered." *Id*.

> Much of corporate practice is not reflected in case decisions or statutes. When lawyers advise business clients on how to squeeze out business associates, the "squeezees" (persons whose elimination from an enterprise is being sought or who otherwise are being oppressed by controlling shareholders) often do not have the will or the money to resist. These cases of course are never reported anywhere, except an occasional one in a newspaper article. In many other instances, an oppressed minority shareholder does go to a lawyer, but the dispute is compromised and settled.

Id.

In South Carolina, we are fortunate that the concept of squeeze-out or oppression of minority shareholders has been definitively discussed by Chief Justice Toal in *Kiriakides v. Atlas Foods Systems & Services, Inc.*, 343 S.C. 587, 541 S.E.2d 257 (2001). Although a recent Business Court Order, *Covan v. Blue Cross & Blue Shield of South Carolina*, 2010-01-08-02, No. 2008-CP-40-5294 (S.C. Common Pleas Jan. 8, 2010), comments on *Kiriakides* and restricts its application to the closely-held corporation, *Kiriakides* has not been commented upon in subsequent appellate cases, possibly because it is such a definitive explanation of Section 33-14-300 of the S.C. Code (Rev. 2006) and the concept of oppression of a minority shareholder in a closely-held corporation.

Kiriakides is a small treatise on what is required to plead and prove the oppression of a minority shareholder in South Carolina. We know,

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for instance, that "South Carolina's judicial dissolution statute was amended in 1963 in recognition of the growing trend toward protecting minority shareholders from abuses by those in the majority." 343 S.C. at 597, 541 S.E.2d at 263. Section 33-14-300 sets out the grounds for a judicial dissolution, including when the directors or those in control of the corporation have acted in a manner that is illegal, fraudulent, oppressive or unfairly prejudicial either to the corporation or to any shareholder. "The statute, as amended, 'broadens the scope of actionable conduct by providing the frozen-out minority shareholder a right of action based on conduct by the majority shareholders which might not rise to the level of fraud.'" *Kiriakides*, 343 S.C. at 597, 541 S.E.2d at 263, n.17. Furthermore, Section 33-14-310 expressly allows the court the discretion to enter an order "providing for the purchase at their fair value of shares of any shareholder, either by the corporation or by other shareholders," and this relief specifically "may be granted as an alternative to a decree of dissolution or may be granted whenever the circumstances of the case are such that the relief, but not dissolution, is appropriate." While there are other causes of action, like common law fraud and breach of fiduciary duty, that may be brought to resist squeeze-out or oppression, that is a subject beyond the scope of this article. To review all of these potential claims, see O'Neal & Thompson, 7-1—7-326.

Instead of focusing on the minority's expectations and whether those expectations are reasonable and not being met by the majority, Section 33-14-300 places the focus upon the actions of the majority—i.e., whether they "have acted, are acting, or will act in a manner that is illegal, fraudulent, oppressive, or unfairly prejudicial either to the corporation or to any shareholder." *Kiriakides*, 343 S.C. at 597, 541 S.E.2d at 263 (quoting S.C. Code Ann. § 33-14-300(2)(ii)). In lieu of defining *oppression*, the Supreme Court found "a case-by-case analysis, supplemented by various factors which may be indicative of oppressive behavior, to be the proper inquiry under S.C. Code § 33-14-300." *Kiriakides*, 343 S.C. at 597, 541 S.E.2d at 263.

Minority expectations v. oppression

Minority shareholders expect fair treatment by those in control of a corporation. When they get something else, minority shareholders holding publicly traded shares call their stockbroker; those holding shares in closely-held corporations call their lawyer. This article is about the latter.

The typical complaint contains many elements of what is known as a *freeze-out*—i.e., those in control of the corporation ("the majority") have caused it to underpay or not pay dividends, salary and other benefits of ownership to the minority shareholder ("the minority"). With little or no market for sale of closely held shares, the minority's investment is essentially frozen, meaning there is little expectation for a return on investment. Within that context, the minority often perceives or imagines other egregious mistreatments and wrongdoings by the majority.

The straw that breaks the camel's back and often leads to litigation comes with the majority's offer to buy the minority's shares at fair market value. Once the minority learns fair market value takes into consideration the frozen nature of the stock, the race is on for a better deal or what appears a better deal—the court ordered buyout at fair value.

To get there, oppression is usually pled and sometimes proven. Pleading oppression is important because South Carolina circuit courts have the authority to dissolve a corporation to protect the minority from oppression. Alternatively, a court may order a buyout of shares of any shareholder either by the corporation or by other shareholders at fair value.

Fair value v. fair market value

The statute specifies fair value as

the standard for setting the buyout price. Unlike the standard of fair market value, the meaning of fair value is far less rigid and may depend entirely upon context, much like the definition of oppression.

The common and generally accepted definition of fair market value is "the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts." Int'l Glossary of Bus. Valuation Terms. Generally, fair market value is proven by expert testimony grounded in empirical data indicating what typical willing buyers and sellers pay for similar assets.

Reliable empirical data, for instance the Mergerstat/BVR Control Premium Study, exists to strongly support the proposition that investors prefer and will pay more for shares that convey the rights to control a corporation than for shares that do not. Other data (restricted stock and pre-IPO studies) supports the proposition that investors prefer and will pay more for liquid shares than for illiquid shares. Those propositions underlie the rationale in fair market value determinations for the minority discount or control premium and the marketability discount or premium, respectively.

Thus, the fair market value of frozen shares in a closely held corporation will usually include a minority and marketability discount, and those discounts are sometimes significant. Fortunately for the minority shareholder, the court ordered buyout remedy looks beyond fair market value and typical "willing buyer/willing seller" considerations to focus upon the fair value or intrinsic value of the shares.

Santee analysis

Although fair value is not defined by the dissolution statute and is ill-defined in the case law, a three-pronged approach described in South Carolina's seminal business valuation case, *Santee Oil Co. v. Cox*, 265 S.C. 270, 217 S.E. 2d 789 (1975), should be reviewed in determining it. Referred to as a "Santee Analysis" by the Court of Appeals in *Belk v. Thompson*, 337 S.C. 109, 522 S.E.2d 357 (Ct. App. 1999), fair value of a corporation's total equity is to be determined from three perspectives: (1) *net asset value* based on the going concern value of all assets owned by the company; (2) *market value* based on the prices paid for comparable businesses; and (3) *earnings value* based on the present value of the company's future earnings stream. *Santee Oil*, 265 S.C. at 274, 217 S.E.2d at 791.

According to *Santee* and in accord with generally accepted valuation methodology, differing value indications under the three approaches should be "weighed as to their relative bearing upon the ultimate question of the fair value of the dissenting stock … and a final determination of value made." *Id*. at 274, 217 S.E.2d at 792.

In *Santee* and *Belk*, the dissenting minority shares were valued pro rata to each corporation's total equity without any adjustment or discount for the actual lack of control rights and pre-merger illiquidity inherent in the minority shares. The omission of such discounts made sense within the dissenter's rights context because the dissented corporate action represented a fundamental and significant change in each shareholder's investment, comparable to sale of the entire company. Because all shareholders share pro rata in liquidation or sale of a company, it follows that fair value in dissenting actions would exclude discounts that might otherwise apply within the context of a sale of only minority shares.

Although the dissenter's rights and the dissolution statutes both specify *fair value* as the standard of value, the case law indicates fair value in one context may not be the same as in the other. The context of oppression differs in that there is no change in the corporate structure, no merger, and typically there is no contemplated sale or liquidation of the corporation.

Discounts

Notwithstanding the contextual differences, some courts have relied upon dissenter's rights valuation methodology in determining fair value in oppression cases. Those courts determine fair value as being equal to the minority's pro rata share of the corporation's total equity; i.e., they allow no discount for the fact that the minority shares lack the valuable right to govern corporate operations or the fact that the shares are less liquid than majority shares.

Thus, applying dissenter's rights valuation methodology in oppression cases results in the court ordered buyout price exceeding the fair market value of the shares, because willing buyers generally pay less for minority, non-controlling shares than majority, controlling shares. They also pay less for reduced liquidity.

Whether oppression justifies a court ordered buyout price greater than fair market value is not clear from the case law. The answer seems to depend upon context even though some of the case law implies a policy decision against discounts. For instance, O'Neal and Thompson note that

> [i]n a buyout where there is a strong likelihood of oppression or other misconduct by those in control of the corporation, an argument for minority discounts would seem even less applicable. Courts in New York, California and elsewhere have fairly consistently held that a minority discount should not be applied in a buyout resulting from an involuntary dissolution proceeding.
> * * *
> Courts are less unanimous in rejecting discounts for lack of marketability although most states have done so.

O'Neal & Thompson § 7:21.

When confronted with discounts in *Morrow v. Martschink*, 922 F. Supp. 1093 (D.S.C 1995), the S.C. District Court flatly rejected them, observing that "normally applied discounts should not be imposed in a forced sale situation." 922 F. Supp. at 1105 (citing *Hendley v. Lee*, 676 F. Supp. 1317, 1330 (D.S.C 1987)). The court went on to observe that "[d]iscounts properly apply to the total value of the company in a 'willing buyer/willing seller' context, but do not apply at all when neither party is willing and the transaction is between insiders." *Id*.

Hendley involved two shareholders in corporate deadlock. The court ordered one shareholder to buy out the other. The buying shareholder sought a discount for the loss of the selling shareholder's services to the corporation—a *key man discount*. *Hendley* rejected application of such a discount because the court concluded the corporation's value would not be diminished by the selling shareholder's absence because any loss would be mitigated by the buying shareholder—a contextual consideration as opposed to policy. The *Hendley* court was not confronted with and did not address minority and marketability discounts.

In *Kreischer v. Kerrison Dry Goods Co.*, Nos. 97-1230, 97-1800, 1999 WL 30836 (Jan. 26, 1999) (unpublished disposition), the Fourth Circuit rejected a minority discount, agreeing with the district court that the facts of the case were analogous to dissenter's rights cases "where such discounts are not awarded because such an award would reward the majority shareholders for their wrongful conduct." 1999 WL at *12. That rationale is appropriate in the dissenter's rights context for more than one reason. As a policy for denying discounts in *Kreischer*, however, it does not mesh with the fact that the district court did not find wrongful conduct, and the Fourth Circuit even observed that the record contained abundant evidence of no oppression.

The Fourth Circuit noted three additional reasons for affirming no discounts in *Kreischer*: (1) like in *Morrow*, the court cited *Hendley* for the "policy" that discounts are not appropriate in forced buyout cases; (2) the rationale behind the discount for lack of marketability "is inapplicable when the transfer results in ownership by one family because it is that absence of marketability that makes the shares valuable to the family;" and (3) notwithstanding the lack of proof and the district court's finding of no oppression, the controlling shareholders were not necessarily innocent and the minority shareholders had suffered a "wrong." 1999 WL at *12.

In contrast, the Court of Appeals ignored multiple indicia of oppression, including embezzlement, conflicts of interest, freeze-out, usurpment of corporate opportunities and excess compensation, in *Phillips v. Brown*, 2004-UP-135 (S.C. App. Feb. 27, 2004), while agreeing with a special referee's determination to apply minority and marketability discounts in the buyout price.

Context matters

It can be expected that courts perceiving oppression contextually similar to dissenter's rights will tend to reject discounts based on policy. However, contextual differences may in certain cases trump policy considerations to ensure minority shareholders are not over or under compensated and controlling shareholders are not punished or rewarded in a buyout.

Minority shareholders in both dissenter's rights and oppression actions essentially allege share value has been unilaterally taken from them by those in control. Aside from punishment considerations, the most equitable remedy in both cases is recovery of what has been taken.

In the dissenting shareholder context, the asset taken is a pro rata share of the corporation. Most of the enumerated acts triggering dissenter's rights involve major corporate actions that permanently change or eliminate the minority shareholder's investment and are analogous to a sale of the entire corporation—at least from the minority's perspective. Thus, it makes sense that the fair value of dissenting minority shares be determined proportionate to the value of the total corporation without regard to specific discounts for lack of control and marketability of the minority shares.

In the context of oppression, while share value may be diminished, the minority shareholder typically continues to hold the same shares with the same legal rights as he or she did before being oppressed. What has been taken is the diminution of fair market value caused by oppression. Thus, fair value under Section 33-14-300 might be determined by reference to the fair market value of the shares assuming the cessation of oppressive acts by those in control.

For example, fair value may assume hypothetical conditions such as the payment of dividends, the payment of only "reasonable" compensation to the majority, *see Blackburn v. TKT & Assocs.*, 387 S.C. 589, 693 S.E.2d 919 (2010), and other conditions that essentially give the minority a seat at the table of corporate governance. Proving the contextual reasonableness or appropriateness of each hypothetical assumption may be critical to the final valuation conclusion.

Conclusion

South Carolina lawyers who represent minority shareholders should be aware that oppressive or unfairly prejudicial conduct by those in control will typically give the minority shareholder a right to be bought out under the dissolution statute. Once that right is established, pursuant to the standards set out in *Kiriakides*, the race is on to establish the fair value of the minority shares. There are a number of factors to consider as the litigation of that issue proceeds, and we have attempted to highlight them here. Experts are commonly utilized, and they are usually given a broad latitude regarding the facts they consider in giving their opinions of the fair value of the minority interest, but most times the real fight in these cases is over the concept of fair value.

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