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Robinson v. Langenbach

Applying valuation discounts in statutory buyouts

In most states, the appropriate standard of value in statutory buyouts is fair value. Unlike fair *market* value, fair value generally excludes discounts for lack of control or marketability. As a result, minority shareholders usually receive their pro rata interest in the company's entire value on a controlling basis. However, courts may have broad discretion in determining fair value based on case facts.

In a recent shareholder oppression case — *Robinson v. Langenbach* — the Missouri Supreme Court upheld the application of valuation discounts to avoid a double recovery. The court noted that it's up to the trial court to determine fair value "by taking into account the context and idiosyncrasies of the particular situation."

Sibling rivalry

The case involved a dispute among three siblings who held equal interests in a closely held corporation. Together, the siblings made up the corporation's board of directors, and the plaintiff sibling served as president and treasurer. When the other siblings became dissatisfied with the plaintiff's performance in June 2012, they voted to remove her as president and treasurer, though she technically remained on the board. They also excluded her from the company's offices and provided no salary, benefits, severance pay or dividends.

The plaintiff sued for breach of fiduciary duty and shareholder oppression under Missouri statutory law. She sought equitable relief in the form of dissolution of the corporation, appointment of a receiver or custodian, or a court-ordered buyout of her shares by the majority shareholders.

At trial, the jury awarded the plaintiff $390,000 in damages for breach of fiduciary duty. That amount was based on the increase in the stock's value during the five-year period between the plaintiff's removal (June 2012) and the trial date (June 2017). In addition, the court found that the defendants had committed shareholder oppression and ordered them to buy the plaintiff's shares for $59,000, based on testimony from the defendants' valuation expert. That value included a 10% discount for lack of marketability and a 15% discount for lack of control.

No double dipping

On appeal, the plaintiff challenged the application

When is it fair to exclude valuation discounts?

A recent decision by the Court of Appeals of Indiana highlights a stock buyback in which valuation discounts for lack of control and marketability were rejected. In *Hartman v. BigInch Fabricators & Construction Holding Company*, the plaintiff served as the company's president and was a minority shareholder. After being involuntarily terminated, the plaintiff requested a buyout of his interest pursuant to a shareholders' agreement.

The agreement called for the buyback price to be based on the interest's "appraised market value." A business valuation professional estimated that the value of the plaintiff's interest was roughly $2.4 million, including discounts for lack of control and marketability. The undiscounted value of the interest was approximately $3.5 million.

The court of appeals reversed the trial court's application of valuation discounts. The appellate court applied fair value concepts, observing that the "fair value" standard isn't limited to statutory buyout cases. It opined that marketability and control discounts "have no application in compelled transactions to a controlling party."

Quoting a federal case applying Indiana law, the court emphasized that "it would be incongruous to discount the shares of the minority shareholder for lack of liquidity when valuation is being done in connection with a proceeding that creates liquidity." The court ruled that applying discounts would create a windfall for the buyers. In theory, the company and its majority shareholders could purchase the plaintiff's shares at a significant discount and then turn around and sell the company for its undiscounted value.

of valuation discounts and the June 2012 valuation date. She argued that the shares should have been valued as of June 2017, the trial date.

The Missouri Supreme Court recognized that discounts have limited application in statutory buyout cases, because they "penalize minority shareholders and encourage misdeeds by the majority." The court explained that all relevant evidence should be considered when determining fair value. There's no fixed set of factors to review and — unlike fair market value, which is based on hypothetical willing participants — "context is crucial" when determining fair value.

In this case, the defendants' expert testified that discounts should be applied to avoid double recovery. The supreme court noted that the jury — by awarding the plaintiff $390,000 in damages for breach of fiduciary duty — had already given her the benefit of the stock's increase in value from 2012 to 2017. The trial court hadn't abused its discretion, the supreme court found, in accepting this argument.

The supreme court also found that the valuation date was appropriate. The relevant Missouri statute specifically defines the valuation date as "the date of the action objected to by the dissenting shareholder." As the trial court explained, using this date ensures that the plaintiff "is neither punished by poor results nor benefitted by extraordinary results occurring in her absence."

Facts matter

Expert testimony is critical in shareholder oppression cases. Fair value depends on the facts and circumstances — and a business valuation specialist can help the court determine value within the context of a specific case. ■

Subsequent events: What was "known or knowable" on the valuation date?

The COVID-19 pandemic has affected the value of many privately held businesses. Some have closed their doors permanently, while others have found market opportunities and prospered.

Hindsight is 20/20. When valuing a business in today's uncertain conditions, experts must put themselves in the shoes of hypothetical investors and consider only relevant information about the pandemic that was known (or knowable) on the valuation date.

Searching for relevant information

When determining the fair market value of a private business, hypothetical willing buyers and sellers are presumed to have made a reasonable investigation of the relevant facts. In addition to facts that are publicly available, reasonable knowledge includes information that a reasonable buyer or seller would uncover during the course of private negotiations over the purchase price.

> *COVID-19 is an ongoing crisis that's having an ongoing effect on many types of businesses.*

Subsequent events — those that happen *after* the valuation date — may be considered when valuing a business if they're reasonably foreseeable and relevant to the question of value. Examples of potentially relevant subsequent events include:

- A pending offer to purchase the business or an interest in the business,
- A bankruptcy filing,
- The emergence of new technology or government regulations,

- A natural or human-made disaster,
- A pending legal investigation or lawsuit,
- An initial public offering, and
- The loss of a key person or major contract.

Not all subsequent events are reasonably foreseeable. For example, you probably can't predict when your company will be affected by a fire, a data breach — or a pandemic.

A subsequent event that's *unforeseeable* as of the valuation date also may be considered if it provides an *indication* of value. An example would be a sale of stock that happens a month after the valuation date. However, unforeseeable subsequent events are usually relevant only if they occur within a reasonable time period and at arm's length.

Factoring COVID-19 into business valuations

The valuation date typically corresponds with the subject company's quarterly or annual financial statement date. For that reason, December 31 is a common cutoff for data that's used to value calendar-year businesses, especially for smaller entities that don't issue interim statements.

Experts consider external market conditions that existed on the valuation date when valuing a business. COVID-19 is an ongoing crisis that's having an

ongoing effect on many types of businesses. What exactly was known or knowable about COVID-19 at the end of 2019 — or the end of each quarter of 2020? The answer depends on how hypothetical investors would have perceived the situation on the valuation date.

For example, some scientists suspect that COVID-19 existed prior to December 31, 2019, but the World Health Organization didn't declare a public health emergency until January 30, 2020 — and it wasn't upgraded to a pandemic until March 11, 2020. Even at the end of March, when Congress passed the CARES Act, many small business owners remained hopeful that the crisis would be resolved during the summer — and that government relief efforts would keep them afloat until then. Unfortunately, the crisis wasn't resolved during the summer, and many businesses continue to struggle or have been forced to close.

What's "reasonably foreseeable" about market conditions that affect a subject company depends on the nature of its operations, its location and the valuation date. For example, some states have continued to prohibit many businesses from reopening at full capacity — or have reinstituted restrictions in response to COVID-19 resurgences — while other states did largely reopen, starting in the summer.

Likewise, some sectors have endured long-lasting setbacks, including restaurants, travel and entertainment. Others — including grocers, big-box retailers, videoconferencing platforms and delivery services — have grown substantially during the pandemic.

Seeking expert opinions

When you hire a business valuation expert, it's important to share all information that could potentially be relevant to the value of the business. This includes information about subsequent events that affect value or provide an indication of value. Once the valuation expert is aware of this information, he or she can determine whether it's appropriate to consider when valuing the business interest. ■

COVID-19 causes upswing in wrongful termination claims

Many employers have furloughed or laid off workers during the COVID-19 crisis. Some of these actions have spurred wrongful termination claims and other types of employment litigation.

Why have claims risen in the COVID-19 era?

Today's unprecedented conditions have led to a surge in employment lawsuits. In one case, an office worker who had requested to work from home to comply with a local stay-at-home order was laid off. She subsequently filed a wrongful termination lawsuit, alleging that she was pressured by her employer to report to work in defiance of local orders (a criminal act) — and then was terminated when she refused. Similar lawsuits have been filed by employees claiming that they were fired for complaining about lack of personal protective equipment or for voicing concerns about co-workers who reported COVID-19 symptoms.

Likewise, terminated employees may file discrimination lawsuits related to the COVID-19 crisis. For example, former employees might allege that

Calculations for defined benefit plans, on the other hand, may require projection of the actual benefit stream following the employee's retirement. Relevant factors include years of service, salary levels, retirement date and life expectancy.

Fringe benefits and perks. To determine the value of fringe benefits, experts compare the benefits received before the alleged wrong to those received after — possibly accounting for the replacement cost of the lost benefits. For example, individual insurance rates may be higher than those paid under an employer-sponsored group plan. Experts distinguish between benefits that depend on the recipient's level of income and benefits that depend merely on being employed.

their employers used the pandemic as an excuse to purge the workplace of older people, people of color or members of the LGBTQ+ community. Additional discrimination claims may happen as companies decide the order in which furloughed employees will return to work.

Which financial estimates are needed?

When estimating lost earnings, financial experts must account for the following types of compensation:

Actual and projected earnings. To determine "base earnings," experts may consider 1) actual earnings in the year before an employee was terminated, 2) projected earnings for the year the termination occurred, or 3) the expected rate of earnings for a year in the future. Adjustments may be required for seasonal variations, commissions, sick pay and nonrecurring payments, such as a non-performance-based bonus and overtime.

Pension and benefit plans. Compensation for lost pension benefits depends on the type of plan involved. For defined contribution plans, employer contributions are considered as a portion of lost earnings in the years the contributions would have been made. Rather than projecting the postretirement benefits to be paid, the expert calculates the sum of the but-for employer contributions and the but-for earnings.

Experts must consider an employee's duty to mitigate his or her damages.

Time frame. The loss period can range from several months to the plaintiff's remaining work life. Selecting an appropriate period requires an analysis of such factors as the plaintiff's likelihood of securing comparable employment and the need for specialized training to qualify for a new job.

Experts also must consider an employee's duty to mitigate his or her damages. Defendants may argue that the employee took an unreasonable amount of time to land a new job or accepted a position at an unreasonably low pay rate.

Need help?

Financial expertise is often critical in employment litigation. Hire a credentialed expert early to help you assess your options and evidentiary needs. ■

Why experts should participate in the discovery process

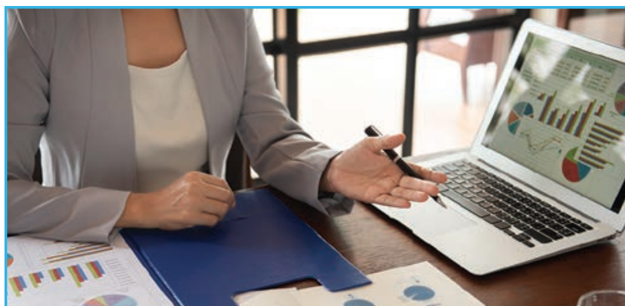
Too often, experts are brought into commercial litigation late in the game — typically after settlement negotiations have failed or just before the case goes to trial. They're asked to perform a valuation or calculate damages with documents obtained during the discovery phase. But this approach — where the attorneys collect the "facts" and the expert analyzes them — can miss valuable opportunities to strengthen the case.

Limited data

Outside a litigation context, valuation professionals don't normally value businesses using only financial statements and management forecasts. They ask for additional information and conduct site visits and management interviews. These procedures help the expert gain a deeper understanding of the business, its management, its industry, its strengths and weaknesses, and the risks that may affect its future performance.

Likewise, in litigation, experts can assist attorneys in crafting deposition questions, interrogatories and other discovery requests designed to dig beneath the financial statements. An expert's early, in-depth involvement can help provide insight into how the company achieved its historical results and what's expected to drive future performance.

Whether valuing an asset or calculating damages — or rebutting an opponent's valuation or damages calculation — a financial expert's analysis is essentially forward-looking. By participating in the discovery process, the expert can gather information and answer questions that support (or challenge) existing assumptions, generate new assumptions and lead to new avenues of discovery.



How early involvement can help

To illustrate this point: Suppose you represent the defendant in a trademark infringement case. The plaintiff seeks to recover damages based on the defendant's profits from the infringing product rather than by establishing and recovering its own lost profits.

In this type of case, the plaintiff normally has the burden of proving the defendant's revenues from the infringing product. Then it's up to the defendant to show the extent to which its revenues are attributable to factors other than the infringement.

A valuation expert can help develop a discovery strategy designed to obtain information about the plaintiff's capabilities in producing and selling the infringed product. This information can be used to show that the defendant possesses distinct advantages over the plaintiff, such as superior manufacturing capabilities, a more extensive distribution network, and a larger sales force and advertising budget. These advantages are independent from the infringement and would allow the defendant to generate greater revenues than the plaintiff.

A winning strategy

Experts who are involved early in the litigation process can help shape the discovery process. This approach helps elicit information that reinforces their opinions and lends credibility to their testimony. ■

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