

Fair Value in Utah

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We've all seen it: shareholders who can't get along. So what happens when the shareholders of a private company can't resolve their differences? In Utah, there are two statutes that govern these situations. The first, known as a judicial dissolution statute, applies when shareholders are deadlocked. This statute allows a shareholder to petition the court to dissolve the corporation or, pursuant to an election, allows the corporation to repurchase shares for fair value. The second, known as a dissident shareholder action, allows minority shareholders that have been "squeezed out" to dissent from the corporate action and receive fair value for their shares.

APPLICABLE STATUTES IN UTAH

Utah Code Annotated Section 16-10a-1430 (2) provides grounds for judicial dissolution by a shareholder in a variety of circumstances. In these instances, the corporation may elect to purchase the outstanding shares of the shareholder at "fair value," under Utah Code Annotated Section 16-10a-1434. Section 1434 does not define fair value, and the definition of fair value under this statute has not been interpreted in a court of law in the State of Utah.

Utah Code Annotated Section 16-10a-1301, provides the guidance in dissident shareholder actions. This statute states:

"Fair value", with respect to a dissenter's shares, means 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. - Utah Code Ann. §16-10a-1301(4) (1992).

THE DEFINITION OF FAIR VALUE

The laws regarding corporations, as well as the laws governing dissenters' rights and corporate dissolution are determined at the state level. As such, fair value, as defined in these statutes is also determined at the state level.

From an appraiser's perspective, the definitions (or lack thereof), provided in the statutes leave many unanswered questions. Because value can mean different things to different people, it is critical in the performance of a business valuation to define value prior to the commencement of the valuation assignment. In the business valuation profession, this is commonly referred to as identifying the standard of value.

Fair value is one of several different standards of value used in the valuation profession¹. Although this nomenclature has been fairly well interpreted by the business valuation community, it is nevertheless important to define the standard of value applied within an appraisal. In fact, the Uniform Standards of Professional Appraisal Practice require that the standard of value be stated and defined within the appraisal report². Nevertheless, because the laws surrounding the “fair value” standard of value have been made and interpreted by those not necessarily versed in valuation theory, the exact definition is somewhat unclear, and raises issues that are not necessarily of concern when using other standards of value. However, we must not disregard the possibility that the statutes are purposefully vague in order to allow for a determination of these issues on a case-by-case basis.

The statutes typically leave much to be desired in terms of providing a clear definition for “fair value” and the impact of controlling vs. non-controlling shares, and marketable vs. non-marketable shares. Absent this definition, the appraiser is left to case law and/or his/her own interpretations regarding the appropriate procedures to use in the performance of the appraisal.

The best interpretation of the Utah statutes is found in cases decided in Utah. Although there are similarities between the statutes of different states, the laws may have been interpreted differently in each of the various states. As such, the appraiser may look to other states’ case law in order to gain insight, however, because of these inconsistencies in interpretation, the appraiser must exercise caution in the application of another state’s interpretation.

FAIR MARKET VALUE VS. FAIR VALUE

Before we discuss the relevant case law in Utah, a definition of fair market value will help the reader understand the vagaries of fair value. Fair market value is defined as the cash or cash equivalent price at which property would change hands between a willing buyer and willing seller, neither being under a compulsion to buy or sell and both having a reasonable knowledge of the relevant facts. This definition does not allow for the value of stock in the hands of any one particular owner. As such, minority and marketability discounts may apply.

By way of contrast, in many states, fair value has been interpreted through case precedent as a pro-rata portion of the control value of the enterprise. Some states allow the application of marketability discounts, while others have taken the approach that the use of marketability discounts should be determined on a case-by-case basis. The application of discounts varies from state to state and has not yet been completely resolved in Utah.

¹ Other standards of value include fair market value, intrinsic value, and inherent value.

² Uniform Standards of Professional Appraisal Practice, Standards Rule 10-2 (a) (v).

Fair value usually differs from fair market value in several respects. Fair market value assumes a hypothetical willing buyer and a hypothetical willing seller, neither being under a compulsion to buy or sell and both having a reasonable knowledge of relevant facts. In the situation of fair value there is rarely a willing seller. Most courts are concerned with the concept of fairness and, as a result, fair value is generally intended to be *equitable* to the unwilling seller.

When the standard of value is fair market value, the appraiser knows, based on the number and proportion of shares being valued, whether or not a controlling value is applicable. Furthermore, when fair market value is the standard of value, the appraiser will typically apply a marketability discount of some sort to the values derived in order to account for the lack of liquidity of the ownership interest.

RELEVANT CASE LAW

There are two cases that help define fair value in Utah. Each of these cases falls under the dissident shareholder statute. Although there are not any decisions that fall under the judicial dissolution statute, the authors have been involved in a case under this statute that was decided in binding arbitration.

Oakridge Energy v. Clifton³

In a case of first impression in Utah, Oakridge Energy, Inc. v. Clifton, the conclusions reached indicated that a fair value appraisal in a dissenting shareholder action should consider each of the three measures of value used in the Delaware block method; namely:

1. Market Value
2. Asset Value
3. Investment Value

Mathematical weightings are then assigned to the indications of value from each of the three measures of value, and the resulting weighted average is the concluded value.

The three approaches to value used in the Delaware block method are akin to the three basic approaches to determining value typically used by appraisers. There are some differences however. Investment value in the context of the Delaware block method means value based on expected earnings and/or dividends. It is similar to the value based on the income approach typically used by appraisers. However, it mixes the traditional income approach and market approach in that it may derive

³ Oakridge Energy, Inc. v. Clifton, 937 P.2d 130, 315 (Utah 1997).

capitalization rates either by traditional income approach methods or by traditional market approach methods⁴.

Market value in the Delaware block method refers to prior transactions in the subject company's securities as opposed to the traditional appraisal concept of market value that uses multiples of both income statement and balance sheet parameters based on comparable companies⁵. However, this does not mean that traditional market approaches do not apply. As will be seen in the case examined in the next section, the court will at least consider evidence regarding comparable companies.

In the *Oakridge Energy v. Clifton* case, the Utah Supreme Court reviewed case law from other states with similar statutes, and noted that the majority of the cases they reviewed indicated that value should be determined based on estimates of fair value using the market value, net asset value, and investment value methods. The Court also noted "the courts have traditionally favored investment value, rather than asset value, as the most important of the three elements." In his book, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, noted business appraiser Shannon Pratt indicates that in reviewing the various court interpretations of the Delaware block method, "Investment value typically is accorded the greatest weight."

Utah's *Oakridge* case did not consider whether discounts should or should not be applied.

Hogle v. Zinetics Medical⁶

In the *Hogle, et al. v. Zinetics Medical, Inc., et al.* case, the Utah Supreme Court considered whether or not the district court "adequately considered the *Oakridge Energy* valuation factors." In this case, both parties to the suit used expert witnesses, and neither party presented any evidence regarding the value of the company using an asset value method. The court was not concerned, noting that because *Zinetics Medical* was a going concern it was not necessary to consider the asset value of the company.

In consideration of the market approach, both appraisers used comparable companies in the determination of value of *Zinetics Medical*. However, the Supreme Court agreed with the district court that the market approach was not relevant. The district court noted, "[n]either expert could discover even one company which could reasonably be characterized as 'comparable' to *Zineteics*."

Although the authors do not believe that this case indicates that the market approach should never be used in determining the fair value of a company in Utah, a close reading of this case highlights the need to use particular caution in choosing comparable companies.

⁴ Pratt, Shannon P., Robert F. Reilly, and Robert P. Schweih. *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 4th Edition, 2000, p. 791.

⁵ *Ibid.*

⁶ *Hogle, et al. v. Zinetics Medical, Inc., et al.*, 2002 UT 121; 63 P.3d 80; 462 Utah Adv. Rep. 31.

By ignoring the asset approach, and by disregarding the market approach presented by the experts in the Zinetics Medical case, the Court's determination of value was based solely on investment value, vis-à-vis the Income Approach.

The Court also considered whether or not marketability or minority interest discounts apply in the determination of fair value in Utah. Quoting the Eighth Circuit Court of Appeals in *Swope v. Siegel-Robert, Inc.*⁷, the Utah Supreme Court noted, "the American Law Institute explicitly confirms the interpretation of fair value as the proportionate share of the value of 100% of the equity, by entitling a dissenting shareholder to a 'proportionate interest in the corporation, without any discount for minority status or, absent extraordinary circumstances, lack of marketability'...fair value in minority stock appraisal cases is not equivalent to fair market value. Dissenting shareholders, by nature, do not replicate the willing and ready buyers of the open market. Rather, they are unwilling sellers with no bargaining power." The court concluded that no discounts should be used in the valuation of Zinetics Medical.

Although Utah's Supreme Court did not allow a marketability discount in the Hogle case, it is the authors' opinion that the issue has not been fully decided. As indicated in the above mentioned quote, there may be circumstances in which a marketability discount is warranted.

As mentioned earlier, one must use caution in reading too much into the decision of the Court, as well as reliance on other states' case law. Nevertheless, a closer examination of the Swope decision (a Missouri case quoted by the Utah Supreme Court in the Hogle case) appears to indicate that the issue of marketability should be determined on a case-by-case basis. In support of this, the Swope decision states in part,

Although both parties in their thorough briefs argue at various junctures that this case or that policy mandates that the Court apply or decline to apply discounts, the principle which emerges most strongly and clearly from *King*⁸ is that such a decision is discretionary. The Court's discussion of Missouri case law, as well as that of other states, must, therefore, proceed with the understanding that no law or policy requiring or forbidding the application of discounts may hold sway with the Court, which is required by its interpretation of Missouri law to rest its decision on its own discretion, *after considering every relevant fact and circumstance*. (Emphasis and footnote added.)

The following quote by Vice Chancellor Jack B. Jacobs of the Delaware Court of Chancery, (the Court which pioneered the use of the Delaware Block Method on which Utah relies), may also prove useful:

Both my Court and the Delaware Supreme Court recognize that valuation cases are extremely fact driven. Very few conclusions on valuation issues have universal

⁷ *Swope v. Siegel-Robert, Inc.*, 243 F.3d 486, 492-93 (8th Cir. Mo. 2001), cert. Denied, 534 U.S. 887 (2001).

⁸ *King v. F.I.J., Inc.*, 765 SW.2d 301 (Mo. App. 1989).

applicability, though statements found in some opinions may have the appearance, and might be interpreted by some, as having sweeping generality.⁹

Non-Published Fair Value in Judicial Dissolution Case

As mentioned previously, the authors are not aware of any case law providing further guidance in judicial dissolution cases, however they were involved in a judicial dissolution case that was settled in binding arbitration. The arbiter in that case had the previously mentioned Utah decisions for consideration in making his decision. In that case, the decision closely matched the decisions in Oakridge Energy and Zinetics Medical, in the sense that the income approach was afforded the most weight. The market approach was afforded some weight; however, that amount was relatively insignificant in the value determination.

The arbiter in this case did not allow a minority discount, however, he did apply a small marketability discount of 15 percent. This decision on discounts is one that the authors believe to be the most theoretically correct, if the purpose of the statute is equity for the parties. An equitable decision might require that a marketability discount be applied because even controlling shares may be non-marketable to some degree. However, it is the authors' opinion that any decision on the applicability of discounts should be done on a case-by-case basis.

Although both the dissenters' rights statute and the judicial dissolution statute both use the term "fair value," it remains to be seen whether the Utah courts will define fair value the same way in each type of case. No doubt some would argue that because fair value was not defined in the minority dissolution statute that the definition of the term "fair value" is the same as that used in dissenters' rights cases. These individuals will likely rely on the Berrett v. Purser & Edwards¹⁰ case, that states that the same term used in different areas of the Utah code are defined the same way. Others will likely argue that the statutes are completely separate, and that an equitable decision would require a different definition of fair value. This argument may have merit, in that the circumstances involving a minority shareholder who has "squeezed out," may be totally different from the circumstances involving equal shareholders who are deadlocked.

CONCLUSIONS

In accordance with the Oakridge case, fair value in the state of Utah requires the appraiser to consider all three basic approaches to value: the asset approach, the market approach, and the income approach. Both the Oakridge and Hogle cases indicate that the courts prefer the income approach when determining fair value. The Hogle case indicates that minority discounts do not apply in dissenter's rights cases;

⁹ Shannon Pratt, "Fair Value: A View from the Delaware Court of Chancery" (interview with Jack B. Jacobs), Business Valuation Update, September 1999, p. 2.

¹⁰ Berrett v. Purser & Edwards, 876 P.2d 367, 369-70 (Utah 1994).

however, marketability discounts may be appropriate depending on the circumstances of the case. Both the Oakridge and Hogle cases were determined under the dissenters' rights statute, and the applicability of these decisions to judicial dissolution cases remains to be seen. As more decisions are made regarding the two fair value statutes in Utah, additional guidance will benefit appraisers.