Morgan Lewis
COUNSELORS AT LAW

NEW JERSEY SUPREME COURT REJECTS APPLICATION OF MARKETABILITY DISCOUNT IN DETERMINING FAIR VALUE IN STATUTORY APPRAISAL ACTIONS

July 1999

www.morganlewis.com

Brussels ■ Frankfurt ■ Harrisburg ■ London ■ Los Angeles ■ Miami ■ New York
Philadelphia ■ Northern Virginia ■ Pittsburgh ■ Princeton ■ Tokyo ■ Washington

New Jersey Supreme Court Rejects Application of Marketability Discount in Determining Fair Value in Statutory Appraisal Actions

July 1999

The state courts are divided on the issue of whether, in a statutory appraisal action, the court should apply a non-marketability discount in determining the "fair value" of stock held by dissenting shareholders in a closely held corporation. The Delaware courts have not allowed such discounts, while the New York courts have taken the opposite view. In two lengthy and thorough decisions issued earlier this month, the Supreme Court of New Jersey addressed this issue and held that marketability discounts generally should not be applied in determining the "fair value" of dissenters' shares in a statutory appraisal action when there is no finding of "extraordinary circumstances" to warrant such a discount. In doing so, the New Jersey Supreme Court became the first to adopt and interpret the American Law Institute's *Principles of Corporate Governance* on this issue. Thus, not only is this case one of first impression in New Jersey, it may also serve as a benchmark for other state courts in considering this recurring issue.

* * * * *

The first case, *Lawson Mardon Wheaton v. Smith,* arose out of a dispute over the management of a family business that had begun as a one-man glass works in 1888 and evolved into a multinational corporation. Following a restructuring of the company in 1991, certain shareholders dissented and demanded that the company pay them the "fair value" of their shares. "Fair value" as used in the New Jersey appraisal statute, as well as in appraisal statutes of other states, is not defined. An appraisal proceeding was filed pursuant to the New Jersey Business Corporation Act. The trial court held that the existence of "extraordinary circumstances" warranted the imposition of a *25%* marketability discount to the determined "fair value." The intermediate appellate court thereafter affirmed, and earlier this month, the New Jersey Supreme Court reversed.

First, the court held that the valuation principles adopted by the American Law Institute's *Principles of Corporate Governance* are appropriate for appraisal. The court emphasized that the very nature of the term "fair value" suggests that courts must take fairness and equity into consideration in deciding whether to apply a discount to the value of the dissenting shareholders' stock in an appraisal action. The court noted that equitable considerations have led the majority of states and commentators to conclude that marketability and minority discounts should not be

This White Paper is published to inform clients and friends of Morgan Lewis and should not be construed as providing legal advice on any specific matter.
©1999 Morgan, Lewis & Bockius LLP

applied when determining the “fair value” of dissenting stockholders’ stock in an appraisal action, although there is no clear consensus.[1]

The New Jersey Supreme Court found most persuasive those cases holding that marketability discounts should not be applied in determining the “fair value” of a dissenting shareholder’s shares in an appraisal action, because any rule of law that gives the shareholders less than their proportionate share of the whole firm’s “fair value” would produce a transfer of wealth from the minority stockholders to the shareholders in control, and that such a rule also would inevitably encourage corporate squeeze outs. Although its review of the history and policies behind dissenters’ rights and appraisal statutes led the court to conclude that marketability discounts generally should not be applied when determining the “fair value” of dissenters’ shares in a statutory appraisal action, the court recognized that there may be situations where equity compels another result. The court held that those considerations are best resolved by resorting to the “extraordinary circumstances” exception in 2 ALl, *Principles of Corporate Governance: Analysis and Recommendations* ¶7.22(a) (1994). According to the ALl, the court should apply this exception only when it finds that the dissenting shareholder has held out in order to exploit the transaction giving rise to appraisal so as to divert value to itself that could not be made available proportionately to other shareholders.

* * * * *

Balsamides v. Protameen Chemicals, also decided the same day, raised a slightly different issue, the resolution of which provides further explanation of the court’s decision in *Lawson Mardon Wheaton.* In that appeal, the primary issue was whether, in a buy-out ordered under the New Jersey “oppressed shareholder statute,” a court should apply a marketability discount to determine the “fair value” of the shares. The court concluded it should.

Balsamides involved a two-shareholder corporation, each owning *50%.* Both shareholders were active in the business. Their relationship soured after they brought their sons into the business, a not uncommon situation. The trial court found that one shareholder was an “oppressed shareholder” who was entitled to buy out the oppressing shareholder’s interest in the business pursuant to the New Jersey “oppressed shareholder statute.” In calculating the “fair value” of the oppressing shareholder’s shares, the trial court applied a *35%* marketability discount. The intermediate appellate court reversed the application of a marketability discount. The Supreme Court, in turn, reversed and held that the “fair value” of the oppressing shareholder’s stock should include a marketability discount. In so concluding, the court relied upon “principles of equity.”

---

1 The court also explained the distinction between a minority discount and a marketability discount. Some courts often confuse these terms. The court held that a minority discount adjusts for lack of control over the business entity on the theory that non-controlling shares are not worth their proportionate share of the firm’s value because they lack voting power to control corporate actions. A marketability discount, on the other hand, adjusts for a lack of liquidity in one’s interest in an entity, on the theory that there is a limited supply of potential buyers for stock in a closely held corporation.

This White Paper is published to inform clients and friends of Morgan Lewis and should not be construed as providing legal advice on any particular matter.

©2001 Morgan, Lewis & Bockius LLP

The court held that the guiding principle applied in this case and in *Lawson Mardon Wheaton v. Smith* is that marketability discounts cannot be used unfairly by the controlling or oppressing shareholders to benefit themselves to the detriment of the minority or oppressed shareholders. Accordingly, the court held that in deciding whether to apply a marketability discount to determine the "fair value" of shares of a shareholder forced to sell his stock in a judicially ordered buy-out, courts must take into account "what is fair and equitable."

The court concluded that to secure "fair value," a marketability discount would be applied in this case because to do otherwise would be unfair, since the selling shareholder was the oppressor and the buying shareholder was the oppressed shareholder. The court stressed that each decision depends not only on the specific facts of the case, but also should reflect the purpose served by the law in that context. The court stated that in both *Lawson Mardon Wheaton* and this case it decided that the "equities of the case" must be considered when ascertaining "fair value" in appraisal and shareholder actions. Application of the equities in the two cases, however, dictated opposite results. In *Lawson Mardon Wheaton,* the corporation, in an attempt to restrict future public sales of the company's stock, approved a plan to restructure the corporation that triggered the rights of dissenting shareholders to demand payment of "fair value" of the shares under the appraisal statute. Therefore, in that case, the court held that in calculating the "fair value" of dissenters' shares, it would be unfair and inequitable to apply a marketability discount because allowing the majority shareholders to buy out the minority dissenters at a discount would penalize the minority for exercising their statutory rights. Moreover, the court concluded it would create the wrong incentives for shareholders in that it would tempt the majority to engage in activities designed to create dissent. It would also encourage the majority to expel troublesome shareholders while simultaneously allowing themselves to profit. Such a result, the court concluded, runs contrary to the appraisal statue. However, in cases where the oppressing shareholder instigates the problems, as in *Balsamides,* the court concluded that fairness dictates that the oppressing shareholder should not benefit at the expense of the oppressed.

* * * * *

The *Lawson Mardon Wheaton* and *Balsamides* decisions give corporate counsel for non-public companies and their shareholders guidance as to how courts will approach the "fair value" determination in an appraisal proceeding. The decisions are significant because they thoroughly survey the case law from other jurisdictions, notably Delaware, and rely heavily upon the analysis of the American Law Institute's *Principles of Corporate Governance.*

For further information, contact Marc J. Sonnenfeld of our Philadelphia office at *215-963-5572* or Robert A. White of our Princeton office at 609-520-6601.