ECONOMIC DAMAGES

The Valuation of Minority Interests in Forced Takings

Julius Koo and Howard Rosen
FTI Consulting

Valuation experts are often tasked with determining the value of an entire business enterprise, such as a 100 per cent interest in the shares of a privately held company. While most dispute-related valuations in international arbitration involve the valuation of a 100 per cent interest or a controlling interest of less than 100 per cent, it is the valuation of minority interests that presents added complexity and requires special considerations.

Generally speaking, minority shareholders are unable to elect a majority of the board of directors, and depending on the nature of the relative shareholdings of other shareholders, may be subject to the will of majority shareholders (with some protections from various Corporations Acts depending on jurisdiction). Shareholder agreements can offer further protection to minority shareholders, but a lack of control can influence the value of the shareholding, and in some cases the effect on value can be material.

While it is the disputes involving controlling interests that garner the most attention due to the relatively higher values at stake of larger percentage ownership interests, minority interests should not be overlooked. This article examines the complexities and considerations faced by valuation experts in valuing minority interests in the context of forced takings in international arbitration.

Controlling interests v minority interests

The definitions of control and rights of shareholders will depend on the jurisdiction in which an entity is incorporated, and what corporate law statutes apply. A valuation expert should be aware of what percentage of shareholder votes are required for significant corporate actions, and the rights of majority and minority shareholders, as these considerations are relevant in determining whether a certain percentage shareholding represents a controlling interest or a minority interest.

For example, in Canada, the Canada Business Corporations Act (as well as the Provincial Corporations Acts) and income tax legislation generally define control and the rights of controlling shareholders. A controlling interest is defined as one having more than 50 per cent of the voting shares of a company. The rights and privileges of a controlling interest include:

- the ability to elect the majority of the board of directors, which allows for control through decisions that influence the strategic direction of the company;
- the ability to appoint themselves or others in senior management positions, which allows for control through operational decisions of the company;
- the ability to determine the timing and quantum of dividends, which allows for control of one’s return on investment;
- the right to determine the timing of the sale of the business, and the amount and form of consideration of the sale; and
- the right to liquidate the business and distribute the proceeds.2

The issue of control is not as simple as having more than 50 per cent of the votes. The ability to pass special shareholder resolutions required to enact ‘fundamental changes’ in the business are set out in the Federal and Provincial Corporations Acts.3 These statutes provide for specific voting requirements in order to pass special resolutions, which may be two-thirds of votes or three-quarters of votes depending on the prevailing statute. A ‘fundamental change’ may be a significant change in the direction of a company, or a sale or liquidation of the business. The requirements to pass special resolutions and other terms of shareholder rights and privileges may also be provided for in a company’s incorporation documents, in shareholders’ agreements or in financing agreements.

In the United States, companies are free to incorporate in any state no matter the location of the headquarters or where business is conducted; however, more than half of all publicly traded companies in the US are incorporated in Delaware.4 Under the Delaware General Corporation Law, the existence of a two-thirds vote requirement essentially gives 33.4 per cent shareholder ability to block certain activities of management and in some cases allow the 33.4 per cent shareholder to maintain an effective controlling interest.

For valuation assignments in international arbitration, it is important for a valuation expert to understand the statutory definitions of control and shareholder rights, if they are provided for in the relevant jurisdiction, and any case-specific factors that influence control. The existence of a shareholder agreement or a review of the articles of incorporation will also provide information that is relevant to the determination of restrictions or protections that are afforded to various shareholders.

Minority interest shareholders are not afforded the same rights and privileges enjoyed by controlling interest shareholders, and thus a valuation expert needs to consider whether adjustments should be made to the pro rata portion of the total value of an entire business enterprise when valuing a minority interest in the context under which the dispute arose. The two most common adjustments are:

- minority discount – a discount for the inability to control the strategic and operational direction of the company; and
- illiquidity discount – a discount for the lack of an immediately ready market in which to sell minority shareholdings, especially for privately held companies and thinly traded publicly held companies.

Definition of value

The starting point of any valuation exercise is to define the concept of ‘value’ being determined. In international arbitration cases, the standard of value is often referred to as ‘fair market value’. Fair market value has different definitions in different parts of the world.

In Canada, the definition of fair market value that has been generally accepted by Canadian courts is:

The highest price available in an open and unrestricted market between informed and prudent parties, acting at arm’s length and under no compulsion to act, expressed in terms of cash.5

In the United States, fair market value is defined by the American Society of Appraisers (ASA) as:
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 arm’s 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.6

While the International Valuation Standards Council (IVSC) does not provide a definition for fair market value, it does provide a definition for ‘market value’ under its International Valuation Standards (IVS) Framework as:

The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm’s length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.7

The concepts outlined in these definitions all have common elements that are generally accepted by valuation professionals globally. These common elements are:

- a willing buyer and seller not under compulsion to transact;
- a knowledgeable buyer and seller at arm’s length;
- an open and unrestricted market; and
- price expressed in terms of cash equivalents.

The other concept of value relevant to the valuation of minority interests is the term ‘fair value’. In the context of valuation for dispute purposes (as opposed to financial accounting purposes), the term ‘fair value’ is not as clearly defined as fair market value and is subject to interpretation by courts and tribunals. Generally, courts in Canada and the United States have interpreted ‘fair value’ to mean fair market value without the application of discounts to reflect the fact that the shareholding being valued is a minority interest. However, the application and determination of fair value in specific cases is complicated in the US, which will vary by state and the circumstances of the case, and to decide on a value that is just and equitable given the specific circumstances of each case. The courts generally apply the concept of fair value, consistent with the appraisal rights noted above.

While the CBCA and Provincial Corporations Acts provide for valuations at fair value, the term ‘fair value’ is not specifically defined in these Acts. Generally, the fair value of a minority interest in dissent and oppression cases has been interpreted by Canadian Courts to mean fair market value without applying a discount to reflect a minority shareholding.10 In the often cited case Douglass Inc v Jarvis, a case heard in the Supreme Court of Quebec relating to dissenting minority shareholders, the Court made the following comment with reference to the definition of fair value:

Thus, a ‘fair’ value is one which is just and equitable. That terminology contains within itself the concept of adequate compensation (indemnity), consistent with the requirements of justice and equity.11

In the Douglass case, the Quebec Court of Appeal considered the question of the applicability of a minority discount and it was held that it was reasonable and correct to reject any discount.12 In Canada, most courts have defined ‘fair value’ as the value that is just and equitable given the specific circumstances of each case. This provides Canadian courts with flexibility and room to judge the applicability of discounts related to the valuation of minority interests.

**United States**

In the United States, as in Canada, the issue of valuing minority interests commonly arises from minority shareholder oppression cases and cases triggering appraisal rights of dissenting minority shareholders. The definition and application of ‘fair value’ in these cases is complicated in the US, which will vary by state and the governing corporate statues adopted in each state. For example, the definition of ‘fair value’ provided for in the 1984 Revised Model Business Corporation Act (RMBCA), under shareholder appraisal rights, did not specifically mention the application of discounts to share valuation.13 Revisions were made in 1999 to the RMBCA to specifically exclude minority discounts and marketability discounts in arriving at fair value.14 However, not all states have adopted the 1999 amendments, and many states, such as New York, have statutes that reflect the 1984 RMBCA definition of ‘fair value’ which allow the courts to decide the appropriateness of applying specific discounts to value based on the facts of the case. Under the Delaware General Corporation Law, a minority shareholder is entitled to an appraisal of the fair value of the shareholdings by the Delaware Court of Chancery, under the appraisal rights available for merger or consolidation transactions.15 In reference to the determination of fair value, the Delaware Court of Chancery is to exclude ‘any element of value arising from the accomplishment or expectation of the merger or consolidation’ and ‘the Court shall take into account
all relevant factors. Therefore, while the fair value concept is used in Delaware, the definition and determination of ‘fair value’ is left open for the court to decide if minority interest related discounts are applicable on a case-by-case basis.

A key distinction in the definition of ‘fair market value’ and what many courts interpret as fair value is the concept of a willing buyer and a willing seller under no compulsion to act. In cases of minority shareholder oppression where minority shareholders are ‘squeezed out’ by majority shareholder actions or in other cases of forcible taking, such as the expropriation of an asset or business by a government, the seller would not be considered as willing and likely are compelled to transact.

In the case McKesson Corporation et al v the Islamic Republic of Iran et al, heard in the United States District Court, District of Columbia, it was found that the defendant had expropriated McKesson’s 31 per cent interest in an Iranian dairy company and that Iran could be held liable in federal court for the expropriation under the Treaty of Amity and customary international law. The Court ruled that the plaintiffs were entitled to an award of damages equal to the ‘full value of the property expropriated’, which is ‘usually “fair market value” where that can be determined’. In the determination of fair market value of this minority interest, the Court rejected the application of a minority discount and a lack of marketability discount. In arriving at this decision, the Court applied what it considered to be analogous domestic law that addressed the legal propriety of minority and marketability discounts in appraisal actions in the United States. It was noted that the overwhelming majority of courts in the United States have found that no minority or lack of marketability discount is appropriate in the valuation of minority interests in an appraisal action when being purchased by the majority shareholder or the corporation itself. In this decision, the Court also observed that:

in a forced sale, discounts are inherently unfair to the forced-out shareholder who did not pick the timing of the transaction and thus is not in the position of a willing seller

because allowing discounts create incentives for oppressive behavior, both discounts are particular disfavored where the stock trade is a result of such behavior.

While the Court acknowledged that these considerations involve interpretation of US domestic corporate law statutes, it found that the position of McKesson as a foreign shareholder facing an expropriating government was analogous to that of the oppressed or ‘forced-out’ minority.

International arbitration

In the ICSID case ADC Affiliate Limited et al v the Republic of Hungary, one of the claimants, ADC Affiliate Limited, held a 34 per cent interest in a project company set up for a renovation and design project of Terminal 2 in the Budapest-Ferihegy International Airport. This arbitration arose from an alleged unlawful expropriation by the Republic of Hungary of the claimants’ investment in and related to this airport project. The Tribunal concluded that the respondent did unlawfully expropriate the claimants’ interest and awarded damages. The Tribunal accepted the discounted cash flow approach as an appropriate method to compute the fair market value of the expropriated investments of the claimants. In the valuation of the 34 per cent interest, the respondent argued that discounts for illiquidity and absence of control should have been applied. The Tribunal rejected the application of these discounts based on the following factors: the project company was a regulated entity with relatively stable cash flows, as opposed to a privately held company with erratic cash flows; and ADC Affiliate Limited, as a minority shareholder, had adequate shareholder protections in the agreements related to the project.

In the ICSID case CMS Gas Transmission Company v the Argentine Republic, the claimant held a 29.42 per cent interest in a company (TGN) set up by the Argentine Republic for the transportation of natural gas. This arbitration arose from the alleged suspension by Argentina of a tariff adjustment formula for gas transmission applicable to the company in which CMS had an investment. The Tribunal concluded that the actions of the Argentine government did not constitute an indirect or ‘creeping’ expropriation, but resulted in the objective breach of the fair and equitable treatment standard. With respect to compensation, the Tribunal concluded that the standard of fair market value was the most appropriate in this case. In the valuation of the loss suffered by CMS on its minority interest in TGN, the Tribunal concluded that the discounted cash flow approach was the most appropriate in this case due to the following factors:

• the shares of TGN were not publicly traded;
• the market capitalisation in the Argentine stock market was illiquid and examining publicly traded natural gas transporters was not the most adequate method to value companies;
• TGN was an ongoing company with a record of profits;
• there was no significant evidence of comparable transactions and it would be speculative to determine compensation on that basis; and
• there was adequate data to make a rational discounted cash flow valuation.

In arriving at the valuation of CMS’ minority interest as described in the public award decision, there was no discussion of whether a minority discount was applied. Interestingly in this case, the value of the shares was determined and awarded on the basis that CMS must transfer the ownership of its shares in TGN to the respondent upon payment of the award, and the respondent was given up to one year after the date of the award to accept the transfer.

In the ICSID case Gemplus SA et al and Talsud SA v the United Mexican States, the claimants together held a 49 per cent interest (Gemplus holding 20 per cent and Talsud holding 29 per cent) in a concessionaire set up by the Mexican government to create and operate a new national motor vehicle registry in Mexico. This arbitration arose from the claimants’ allegations against the respondent of:

• unlawful expropriation;
• unfair, inequitable and arbitrary treatment; and
• failure to provide full protection and security in regard to their investment in the concessionaire.

The Tribunal concluded that the claimants’ investments were unlawfully expropriated by the respondent, indirectly with the requisition of the operation of registry and directly with the revocation of the concession agreement. With respect to compensation, the Tribunal concluded that the claimants’ claims derive only from their status as investors with minority shareholdings in the concessionaire. The relevant exercise to the Tribunal was the valuation of the claimants’ lost investments in the form of their minority shares. With respect to the definition of value, the Tribunal referred to the Argentina bilateral investment treaty, which provides for the equivalent of the ‘market value’ of the shares, and the France bilateral investment treaty, which provides for the equivalent of the ‘fair market value’ of the shares. Some of the difficult valuation issues that the Tribunal contended with in this case include the following:
The concession was intended by the respondent and the claimants to be a profitable investment, but the project never achieved the level of profitability contemplated by the concession’s business plan. The Tribunal considered that it still retained a reasonable opportunity to make significant future profits until the time of the respondent’s unlawful conduct.

The Tribunal accepted that there was no ‘open, public, active or other available market’ for the claimants’ shares in the concessionaire and that there was no comparable business at the valuation date.

The Tribunal rejected the use of the discounted cash flow approach by the claimants as an appropriate methodology, and accepted the respondent’s contention that the status of the concessionaire’s business prior to and up to the valuation date was ‘far too uncertain and incomplete to provide any sufficient factual basis for the DCF method’.

In expressing its reservations of the claimants’ use of the DCF method in this case, the respondent submitted that a prospective buyer of the claimants’ shares would be acquiring a minority interest and, as such, would normally command a discount. The respondent further submitted that a fully informed arm’s length purchaser contemplating the purchase of this minority interest would demand a ‘very high discount’.

The Tribunal also rejected the respondent’s use of the asset approach and the use of declared tax values since neither of these approaches takes into account the concessionaire’s most valuable intangible asset as at the valuation date, being the reasonably anticipated future income stream from the concession agreement under the remaining term of 10 years.

With respect to the underlying data, the Tribunal noted that it was a material consensus by the quantum experts that the accuracy of much of the underlying data used in the discounted cash flow approach was not in dispute, even though the use of the DCF method itself was disputed.

Having made the above considerations, the Tribunal applied a modified form of the income-based approach to value the claimants’ minority shares in the concessionaire by reference to the concessionaire’s ‘reasonably anticipated loss of future profits’ assessed at the valuation date.

Considerations in the valuation of minority interests

A valuation expert should first consider the type of business enterprise that is the subject of the valuation, whether it is a publicly traded corporation, a privately held company, a joint venture or partnership, or a government regulated enterprise. This will have an impact on the valuation methodology and the applicability of a minority interest. For example, using public stock market share prices and trading multiples to arrive at the value of a particular block of shares will in part already include an inherent minority discount since stock prices reflect the publically quoted price of one share, which is a non-controlling interest. However, shares of publicly traded companies if they are highly liquid may to some extent mitigate the perceived minority discount in stock market trading prices. As illustrated by the international expropriation cases above, the valuation of government-regulated entities set up for specific projects will have special considerations, such as whether there are any true comparable publicly traded companies or transactions, whether the entity generated stable historical positive cash flows or the reasonable expectation to generate future cash flows, and whether there are project agreements that provide protections for minority interests involved.

In addition to the ownership percentage being valued, a valuation expert should also understand the ownership structure and the rights and privileges of the shareholding interest. Documents such as articles of incorporation and shareholder agreements may provide information on restrictions or protections that affect various shareholders. The jurisdiction under which the company was incorporated will also have an impact on ‘control’, such as the provision of specific voting requirements to pass special resolutions that require more than 50 per cent of shareholder votes.

Understanding the cause of action and the dispute that gave rise to the valuation exercise is equally important. In cases involving shareholder dissent rights, compulsory purchase transactions, shareholder oppression and expropriation, shareholder interests are often considered forcibly taken. These transactions involve parties that would be considered unwilling ‘sellers’ under compulsion to transact. Depending on the jurisdiction and the cause of action, the valuation expert should clearly define the standard of value and understand the applicability of fair market value and fair value in the particular jurisdiction. The valuation of these minority interests should reflect a willing buyer and a willing seller not under any compulsion to transact.

Notes

1 The authors would like to thank Vlad Moliseykin for his assistance in researching and writing this chapter.
4 www.corp.delaware.gov/aboutagency.shtml
6 ASA Business Valuation Standards, 2009, p.27.
10 Canadian court cases which address fair value and the exclusion of minority discounts include: Brant Investments Ltd v KeepRite Inc, Court of Appeal for Ontario (CA 837/87); Ford Motor Company of Canada v the Ontario Municipal Employees Retirement Board, Court of Appeal for Ontario (CA41312 & CA41450); Sutherland v Birks, Court of Appeal for Ontario (C37495).
11 Domglas Inc v Jarlskow, Supreme Court of Quebec (13 BLR135), as cited in Manning v Harm Steel Group Inc, Supreme Court of British Columbia.
12 Domglas, as cited in Irwin v DW Coates Enterprises Ltd, Supreme Court of British Columbia.
15 The Delaware Code, Title 8, Chapter 1 – General Corporation Law, section 262(a).
16 The Delaware Code, Title 8, Chapter 1 – General Corporation Law, section 262(h).
17 United States District Court, District of Columbia, No. CIV. A.82-00220[TAF].
18 ICSID Case No. ARB/03/16.
19 ICSID Case No. ARB/01/8.
20 ICSID Case No. ARB(AF)/04/3 & ARB(AF)/04/4.
Julius Koo is a managing director at FTI Consulting in the economic and financial consulting practice based in Toronto, Canada. Julius has practised exclusively in the areas of business valuation; financial litigation, including the assessment of damages; and related matters since 2004. His current work focuses on business valuation for mergers and acquisitions, and divestitures; shareholder disputes; financial reporting matters; income tax purposes; fairness opinions for securities regulations; and quantification of damages related to complex commercial disputes and international arbitrations.

Julius has prepared independent business valuation reports for public and private companies in a wide range of industries, and has prepared independent expert reports on damages related to disputes arising in North America, South America, Europe, and Africa. He has prepared numerous expert reports filed in various courts, such as the Federal Court of Canada and the Ontario Superior Court of Justice. He has also been involved in preparing expert reports for international arbitrations in various arbitral institutions, including the International Centre for Settlement of Investment Disputes, the ICC International Court of Arbitration and the International Arbitral Centre of the Austrian Federal Economic Chamber.

Julius graduated from the University of Waterloo’s School of Accountancy in 1999 where he obtained a master’s degree in accounting. He obtained his chartered accountant designation in 2001 and his chartered business valuator designation in 2007. His prior work experience includes assurance and business advisory services to privately held, owner-managed businesses in a diverse range of industries with an international accounting firm.

Howard Rosen is a senior managing director at FTI Consulting and has been involved exclusively in business valuations, damages quantification and corporate finance-related matters since 1981. He has acted as an adviser to private and public companies, regulatory bodies and all levels of government on a wide variety of industries. His work experience covers assignments across North and South America, Europe, the Middle East, Africa and Asia. Howard has provided expert witness testimony in over 200 damages quantification and valuation matters in courts in Canada and the United States and also in International Arbitration hearings in North and South America, Asia, Africa, Europe and the Middle East.

Howard has acted as court appointed administrator, monitor and inspector, and sat as a member of an arbitral tribunal and sole arbitrator. He is the co-author of two texts on the quantification of economic damages and has lectured extensively to professional interest groups. Howard has acted as instructor at the NITA and FIAA expert witness trial practice programs, the MIIDS programme in Geneva, and as an MBA instructor at the Schulich School of Business in Toronto. Howard has been listed as one of the top valuation and damages experts in Canada by Lexpert, and internationally by Who’s Who Legal as one of the top experts in international commercial arbitration.

Howard's corporate finance experience extends to private equity investments, and managing investments through liquidity transactions, including sale to strategic buyers and IPO.

Howard leads the global international arbitration practice for FTI Consulting.