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## Fair Value of Minority Shares in a Closely Held Company

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*This article examines the notion of fair value for minority shares in a closely held company and whether fair value of a minority stake should incorporate a discount from the pro rata value of the company's equity considered as a whole.*

*In general, fair value has to be equitable to the acquirer and the vendor, recognising what the seller gives up in value and what the buyer receives through the share acquisition. However, fair value is not a single valuation standard but is a contextual assessment. The context influences whether a discount ought to apply in determining the fair value for minority shares.*

*While the baseline position is that fair value may include a discount for minority interest, there are contexts where a discount would not apply. One is where a company's constitution prescribes a formula to determine fair value and this is a pro rata value of the total value. Where a company's constitution provides for an expert to determine fair value without being explicit on whether a discount applies, then the expert will have a discretion.*

*In cases where directors are dealing in shares and have material inside information, s 149 of the Companies Act 1993 is relevant, and court decisions suggest a nuanced approach to whether a minority discount applies. A minority discount may apply where the transaction is an open market consensual transaction. However, no discount is likely to apply in the case of a closely held company where shareholders have fallen out, or where the company constitution gives a minority greater than usual rights.*

*The Companies Act 1993 also considers fair value where minority buyout rights apply, and where a shareholder is oppressed, unfairly discriminated, or unfairly prejudiced. The Companies Act 1993 and the court decisions typically conclude that fair value in these contexts is a pro rata value exclusive of a discount for minority shares.*

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### 1 INTRODUCTION

A minority shareholder in a closely held company could be in an unenviable position when issues arise between them and the majority shareholder. While minority shareholders in a publicly listed company could sell their shares in the open market at the prevailing market price, neither a market nor a price exists for shares in a closely held company, notwithstanding the existence of pre-emptive rights.

Minority shareholders in a closely held company must rely on “statutory” or “contractual price fixing provisions”<sup>1</sup> for the valuation of their shares. A statutory provision such as s 149 of the Companies Act 1993 prescribes fair value, while some contractual arrangements specify fair market value<sup>2</sup> or an agreed price.<sup>3</sup> The courts have set aside these contractual provisions in favour of fair value<sup>4</sup> for internal transactions that involve one or more directors of the company (as either seller or buyer) where s 149 applies.

This paper examines the notion of fair value for minority shares and, in particular, whether fair value of a minority stake should incorporate a discount from the pro rata value of the company’s equity considered as a whole.<sup>5</sup>

The question of whether a discount should apply depends on the nature of the “fair value” test. Is fair value a professional valuation standard or is it a statutory test? The contribution and thesis of this paper is that fair value is not a single valuation standard but is contextual in nature. For example, one could argue that the professional standard of fair market value may meet a test of fair value for a minority interest in a widely held company and in a publicly listed company, but this may not be so in a closely held company.<sup>6</sup>

Further, the circumstances in which a shareholder is exiting a company are important. For a fair value assessment under a constitutional or contractual valuation, the context of the constitution or contract as a whole will be important in interpreting and applying the concept of fair value. On the other hand, if a shareholder is exiting because of fundamental changes to the company that the shareholder has opposed or because of alleged prejudicial conduct by management, the assessment of fair value will likely be different from when a shareholder is willing to sell their shares and there is no question of unfair conduct.

The paper is set out as follows. Section 2 defines a minority shareholding. Section 3 then discusses the value of a minority shareholding and whether it inherently involves a discount for minority shares.

Section 4 examines the valuation of minority shares transacted under pre-emptive rights and other constitutional and contractual arrangements.

Section 5 examines s 149 of the Companies Act 1993. Under s 149 the directors of a company who hold price sensitive, non-public information obtained in their capacity as a director or employee must pay no

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1 *Fong v Wong* [2010] NZSC 152, (2010) 20 PRNZ 250 at [8].

2 The deed of dissolution in respect of shareholders of Pavé Capital Ltd in *Fong v Wong* HC Auckland CIV-2008-404-5547, 4 December 2008 provides for a fair market value of the shares to be transferred from the defendants to the plaintiffs.

3 *Thexton v Thexton* [2002] 1 NZLR 780 (CA).

4 *Fong v Wong* HC Auckland CIV-2008-404-5547, 4 December 2008 and *Thexton v Thexton* [2002] 1 NZLR 780 (CA).

5 Fair value of a minority interest in a publicly listed company is different from fair value of a minority interest in a closely held company. In *Fong v Wong* [2010] NZCA 301 at [16], the Court of Appeal quotes Mr Hagen, a share valuation expert, as saying that “I am not of the view that the standard of ‘fair value’, of itself, bars the application of a discount for minority shareholdings. ... if the shareholding was a small minority in a widely held company with no unusual rights then I would expect a minority discount to apply.”

6 In fact, counsel for the applicants in *Fong v Wong* [2010] NZSC 152, (2010) 20 PRNZ 250 argued that professional valuation standard of fair market value may met the statutory test of fair value for a minority interest in a closely held company.

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less than fair value when buying shares in that company and must receive no more than fair value when selling them.

Section 6 looks at buyouts where a shareholder exercises statutory buyout rights under ss 110 or 118 of the Companies Act 1993, and section 7 examines the valuation of minority shares in the case of unfair prejudice and a remedial order under s 174.

We provide some guidelines in section 8, and a summary and conclusion in section 9.

### **2 MINORITY SHAREHOLDING**

In general, a minority shareholding is any shareholding of less than 50 per cent of a company. However, for assessing the valuation of a shareholding in a company, a different definition is appropriate. That is, a minority shareholding is a shareholding that is insufficient to provide any ability to exert control or influence over decisions of the company.

In New Zealand, a shareholding below 25 per cent normally provides no real ability to prevent important corporate actions, and a shareholding below 50 per cent only provides limited ability to control corporate decision-making.

Unless the constitution provides otherwise, a majority (51 per cent) of shareholders can determine the composition of the board of directors who will then have the ability, under s 128 of the Companies Act 1993, to manage the affairs of the company. Further, unless the constitution provides otherwise, shareholders who hold 75 per cent of the company can pass special resolutions to authorise major transactions, including the sale or purchase of assets worth more than half the value of the company's assets, or to amend the company's constitution.

A company's constitution can change these default settings so that the holder of what appears to be a relatively small per centage shareholding can obtain greater rights than would otherwise occur. For example, a company's constitution might provide that a shareholder with only a 20 per cent shareholding nevertheless has the ability to appoint one or more directors of the company and may restrict the ability of the other shareholders to appoint further directors so that the minority shareholder's proportionate level of board representation is preserved.

The constitution might also provide that certain important business decisions require the approval of a super-majority of shareholders defined in such a way as to ensure that the minority shareholder agrees.

Further, the constitution might provide that a special resolution of shareholders necessary for the shareholders to pass a resolution to amend the constitution or put the company in liquidation require a higher majority of shareholders than 75 per cent, again calculated in such a way as to ensure that the minority shareholder agrees.

If a minority shareholding does not give the shareholder influence or control, how does that affect the value of the minority shareholding? That, in turn, might depend on the standard of value that should be applied to the assessment of value.

### 3 STANDARDS OF VALUE

A valuation could be required by law, for example, in a compulsory acquisition of minority shares under ss 110 or 118 of the Companies Act 1993, for matrimonial settlement, following death of a shareholder, or by contract as in a takeover or in a buy-sell agreement.

The meaning of value differs across individuals and contexts, which is why it is important to define the standard of value that is required. This paper focusses on the use of “fair value” as the relevant standard of value for a proposed transfer of a minority shareholding but, first, by way of contrast we discuss the alternative standard of “fair market value”.

Where “fair market value” is the relevant standard, one assumes a willing seller and a willing buyer where both parties have reasonable knowledge of the relevant facts and neither party is acting under compulsion.<sup>7</sup> Pratt and others indicate that the willing seller and willing buyer are hypothetical persons dealing at arm’s length and are not any particular or specified seller or buyer who are transacting for a special reason.<sup>8</sup> Essentially, the willing seller and willing buyer are your typical seller and buyer in the market who are transacting based on the prevalent economic and market conditions at the transaction date and based on the parties being informed and knowledgeable about the company’s performance and capabilities.

Shishido suggests that the amount that a hypothetical person would pay “is a matter of positive analysis”, which “considers the conflicts of interest among shareholders, and the hypothetical market values of the minority stock and the majority stock”.<sup>9</sup> These values are different, and the difference is the control premium arising from the conflicts of interest between the majority and minority shareholders. An example that illustrates the conflict is when the controlling shareholder does not permit payment of dividends or suppresses dividend payments to the minority shareholders. The hypothetical market value assumes the presence of an informed open market where a transaction takes place on an arm’s length basis at a market price. Market forces apply in such a market, and there is accordingly generally a discount for a minority stake.

The analysis of a typical willing seller and willing buyer in the market where they are transacting based on the prevalent economic and market conditions will normally suggest that such participants will place less value on a minority stake than a pro rata percentage of the whole company value. This is self-evident when the minority stake creates less ability to control and influence the affairs of the company for the reasons discussed in section 2 above.

Because a minority shareholding does not enjoy the same valuable rights that a majority shareholding enjoys, the former’s comparatively inferior position is worth less than the pro rata proportion of the entire equity. The discount is the reduction from the pro rata proportion of the entire equity to reflect the absence of these control rights. The quantum of the discount is subjective, and it could range from 30 per cent in the PwC valuation in *Fong v Wong*<sup>10</sup> to 40 per cent in United States (US) closely held companies.<sup>11</sup>

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7 *Holt v Holt* [1990] 3 NZLR 401, (1990) 7 FRNZ 203 (PC).

8 Shannon P Pratt, Robert F Reilly and Robert P Schweih *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* (4th ed, McGraw-Hill, New York, 2000) at 29.

9 Zenichi Shishido “The Fair Value of Minority Stock in Closely Held Corporations” (1993) 62 *Fordham L Rev* 65 at 66 and 70. Michael Jensen and William Meckling “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure” (1976) 3(4) *Journal of Financial Economics* 305 indicate that the separation of ownership and control creates conflicts of interest between shareholders and managers, and shareholders (represented by the managers) and creditors.

10 *Fong v Wong* HC Auckland CIV-2008-404-5547, 4 December 2008 at [12].

11 Shannon P Pratt, Robert F Reilly and Robert P Schweih *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* (4th ed, McGraw-Hill, New York, 2000) at 372.

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The concept of “fair value”, however, does not necessarily equate to fair market value, and it is less clear whether a discount for a minority stake should apply. The context in which “fair value” is used is important.

The standard of fair value applies in a number of different contexts. It is written into statute in s 149 of the Companies Act 1993, is applied by the courts in valuing shares on compulsory purchases of shares under s 174, and is a common standard used for valuation of shares in a company’s constitution.<sup>12</sup> It is also a standard that is commonly used in the United States for assessing the fairness of transactions in which company officers have an interest (such as a management buyout) or where a breach of fiduciary duty is alleged.<sup>13</sup>

Shishido says, “fair value is a matter of normative analysis” that considers “economic fairness among shareholders”. It concerns “how much the buyer *should* pay for the minority stock in the case of a buyout or appraisal” (italics in original) and this requires “a correction of the inequalities that rise from the conflicts of interest between majority and minority shareholders”.<sup>14</sup>

The Court of Appeal in *Re James Davern Ltd* endorsed the following proposition for “fair value”:<sup>15</sup>

Fair value is based on the desire to be equitable to both parties. This recognises that as the transaction is not on the open market, the buyer has not been able to look around for the lowest price, nor has the seller been able to hold out for the highest price. Fair value recognises what the seller gives up in value and what the buyer acquires through the transaction.

In *MMAL Rentals Pty Ltd v Bruning*, the Chief Justice of the New South Wales Supreme Court said that a fair value is “what is just or equitable in all circumstances”.<sup>16</sup> The Chief Justice went on to say:<sup>17</sup>

In a contractual context, [fair] suggests that the valuation should proceed on the assumption, which may be contrary to the facts of a particular contractual relationship, that there is no impediment to the process of bargaining, whether in terms of availability of information or restraints arising from the characteristics of a particular vendor or purchaser or otherwise.

In *Fong v Wong*, Asher J said, “‘fair value’ has to be assessed objectively, on a case by case basis, after an examination of all the relevant circumstances. Those circumstances can include oppressive behaviour by a majority shareholder.”<sup>18</sup>

Importantly, the likely applicability of a discount that reflects the non-controlling status of minority shares differs as between fair market value and fair value. Fair market value will usually require a discount, while fair value may do, but often does not.

Heath J in *Glaister v Amalgamated Dairies Ltd* held that “ordinarily, in applying ‘fair value’ (as that term is understood by valuers) a discount will be applied to reflect the lack of power or liquidity available to the minority shareholder”.<sup>19</sup> However, as we will see, that is often not the case. It depends on the particular context in which fair value is determined. In particular, where there is a breakdown in relationships between

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12 Pavé Capital Ltd’s constitution in *Fong v Wong* HC Auckland CIV-2008-404-5547, 4 December 2008.

13 John C Coates IV “Fair Value” as an Avoidable Rule of Corporate Law: *Minority Discounts in Conflict Transactions* (1999) 147 U Pa L Rev 1251; *Weinberger v UOP, Inc* 457 A 2d 701 (Del 1983).

14 Zenichi Shishido “The Fair Value of Minority Stock in Closely Held Corporations” (1993) 62 Fordham L Rev 65 at 66.

15 *Re James Davern Ltd* (1996) 9 PRNZ 456 (CA) at 459.

16 *MMAL Rentals Pty Ltd v Bruning* [2004] NSWCA 451, (2004) 63 NSWLR 167 at 176.

17 *MMAL Rentals Pty Ltd v Bruning* [2004] NSWCA 451, (2004) 63 NSWLR 167 at 177.

18 *Fong v Wong* HC Auckland CIV-2008-404-5547, 4 December 2008 at [34].

19 *Glaister v Amalgamated Dairies Ltd* [2003] 1 NZLR 829 (HC) at [70].

shareholders in a closely held company, and particularly where the exiting shareholder is subjected to unfair conduct, a minority discount will likely not be applied.

Depending on the context in which fair value is assessed, fair value is more likely than fair market value to be based on a pro rata share of the total equity value. “Fair value” is based on a normative analysis of what the buyer *should* pay the seller, that is, what is just and equitable between the parties recognising what is being given up by one party and received by the other. It is less self-evident than in a fair market assessment that the assessment of the fair value of a minority shareholding should necessarily require the application of a discount.

We now discuss various contexts where fair value applies and in each case assess whether that context does or does not require the application of a discount to the assessment of the fair value of a minority shareholding.

#### 4 EXERCISING PRE-EMPTIVE RIGHTS

Some companies give their shareholders pre-emptive rights to purchase shares before non-shareholders can purchase them. Pre-emptive rights require a vendor shareholder to first offer the shares to existing shareholders.

Where the share transfer is at fair value pursuant to pre-emptive rights (or some other constitutional or contractual share transfer provision), there will not be a presumption of no minority interest discount. Rather, the reverse is true. The starting point is that fair value does allow for a minority interest discount, but the particular wording of the company constitution or relevant contractual document can change this presumption.

##### 4.1 Fair Value in a Formula Prescribed in the Constitution

*Glaister v Amalgamated Dairies Ltd* is an example of a case relating to the transfer of shares under pre-emptive rights provisions and a constitutional provision providing for fair value.<sup>20</sup> The case shows the readiness of the courts to accept both (a) that as a general rule the concept of fair value allows for a minority interest discount, and (b) that the specific wording of the constitutional provision can override this general rule.

In *Glaister*, the Court held that although the constitution used the term “fair value”, the valuation methodology prescribed in the constitution was mathematical in nature and this implicitly required an assessment of value by reference to a calculation of net assets without the application of a minority discount.

This case involved the late Mr Glaister who was a long-standing employee and director of Amalgamated Dairies until his death in 2000. As part of his employment, Amalgamated Dairies granted Mr Glaister 3.5 per cent of the share capital; the Goodfellow family held the remaining shares.

A 1976 Deed specified that, on termination of Mr Glaister’s employment, the Goodfellow family would reacquire the shares “at a price then to be fixed by the auditor of Amalgamated as being the value of the said shares at the time of such notice”. The resolutions relating to the issue of shares referred to specific articles in the Articles of Association, which became cl 4.7 of the constitution following reregistration of Amalgamated Dairies under the Companies Act 1993.

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<sup>20</sup> *Glaister v Amalgamated Dairies Ltd* [2003] 1 NZLR 829 (HC). One of the authors (John Land) was counsel for Amalgamated Dairies Ltd in this case.

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Clause 4.7 described the value as “fair value”, which was “the proportion borne by the said shares to all other shares of the company entitled to benefit from the said sum”. Heath J interpreted cl 4.7 as follows:<sup>21</sup>

...the term “fair value” is defined as the result of a calculation whereby the “sum of the surplus assets,” as ascertained by the formula set out in cl 4.7, is multiplied by the per centage of shares held by the shareholder required to sell. There is no room for the exercise of any judgment which would entitle the application of a minority discount. I therefore hold that it was inappropriate for a minority discount to be applied.

He went on to say the parties had intended to use two factors to arrive at “fair value”: the sum of the surplus assets and the per centage of shares held by the prospective seller. He did not think “these experienced men of commerce intended the price to be paid for the shares to depend on the judgment formed by the auditors on the appropriate discount to apply”.<sup>22</sup>

Heath J disagreed with the two experts for Amalgamated Dairies, Mr Hagen and Mr Bridgman, who were of the view that a valuation without a minority interest discount “would lead to a result which could be characterised as ‘stupid’, ‘silly’ or ‘almost nonsensical’”. He reasoned that:<sup>23</sup>

[t]hose who will be affected by the result of a share valuation have the ability to set the rules by which the shares shall be valued. A formula which meets the needs of particular parties and is regarded by them as producing a ‘fair value’ may not meet the needs of others, who may not regard the result as ‘fair’.”

In summary, the judgment by Heath J suggests the following:

- “[O]rdinarily, in applying ‘fair value’ (as the term is understood by valuers) a discount will be applied to reflect the lack of power or liquidity available to the minority shareholder” (emphasis added).<sup>24</sup>
- However, the context can change this, and fair value can have a special meaning in a constitution. It can specify an arithmetic formula rather than the exercise of judgment by a valuer. Where this occurs, it will be an error of law for the valuer not to follow the valuation instruction.<sup>25</sup>
- Where the parties agree on an arithmetic formula that does not stipulate a minority interest discount, as in *Glaister v Amalgamated Dairies Ltd*, fair value of the minority interest is a pro rata value of the total share value.

### **4.2 Fair Value to be Fixed by an Expert**

Where, however, a constitutional provision or contract provides for a valuer to determine “fair value” without providing further guidance, a court will treat the valuer as having considerable discretion in assessing fair value. That discretion will likely extend to the valuer being able to decide whether to apply a minority discount.

An example is *Hay v Peregrine Estate Ltd*.<sup>26</sup> The constitution of Peregrine Wines Limited governed the sale of shares by and between shareholders of the company. The transfer of shares in exercise of the

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21 *Glaister v Amalgamated Dairies Ltd* [2003] 1 NZLR 829 (HC) at [93].

22 *Glaister v Amalgamated Dairies Ltd* [2003] 1 NZLR 829 (HC) at [95].

23 *Glaister v Amalgamated Dairies Ltd* [2003] 1 NZLR 829 (HC) at [94].

24 *Glaister v Amalgamated Dairies Ltd* [2003] 1 NZLR 829 (HC) at [70].

25 *Glaister v Amalgamated Dairies Ltd* [2003] 1 NZLR 829 (HC) at [44].

26 *Hay v Peregrine Estate Ltd* [2016] NZHC 2097.

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pre-emptive rights was set out in cl 11 of the constitution which required the transfer to be “At the ‘fair value’ of the shares as fixed by the expert”.<sup>27</sup>

The plaintiff owned 25.14 per cent of the shares in Peregrine Wines Limited and had offered the shares to the defendant. The price was not acceptable to the defendant, who owned the remaining shares. Both parties invoked cl 11 of the constitution. Clause 11.4 set out the appointment of the expert and stipulated that “[t]he value fixed by the expert is ‘fair value’”.

Ms Julie Millar of BDO, Christchurch, was appointed in accordance with cl 11.4; her appointment was not disputed. Ms Millar fixed the fair value at \$2.62 million. At the High Court, the plaintiffs sought specific performance by way of a summary judgment of the defendant’s obligation to buy the shares at the value fixed under cl 11.4.

The defendant, Peregrine Estate Limited (hereafter PEL), consulted another expert, Mr Hagen, who assessed the fair value at \$1.275 million. Despite the significant difference between the two valuations, counsel for both parties “focussed their argument on whether PEL is bound by the Millar valuation or not.”<sup>28</sup>

Counsel for PEL argued that the Millar valuation was “flawed and unenforceable” because Ms Millar did not apply a minority discount to the valuation and that she consulted with Chapman Tripp and sought their opinion on whether a minority discount ought to apply.<sup>29</sup> Hence, she did not apply independent judgement, as she was required to do.

Associate Judge Matthews noted that Ms Millar considered a minority interest discount was appropriate in determining fair market value, but not in relation to fair value.<sup>30</sup> Further, he found that Ms Millar had already decided that she would not apply a minority interest discount before she received the Chapman Tripp advice to the same effect.<sup>31</sup>

On PEL’s appeal to the Court of Appeal, the Court took the view that the validity of Ms Millar’s assessment of fair value depended on whether “she carried out the valuation exercise dictated by the constitution.”<sup>32</sup> The Court said that cl 11.4(4) of the constitution indicated that “[t]he value fixed by the expert *is* the ‘fair value’”<sup>33</sup> and that the “parties agreed to be bound by the independent expert’s assessment, not that of the court.”<sup>34</sup>

The Court of Appeal noted:<sup>35</sup>

It was entirely up to Ms Millar to determine the fair value of the shares, not the Court. Ms Millar correctly identified the shares to be valued and applied the ‘fair value’ approach. She made no error in observing

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27 Clause 11.1(2)(b)(ii) of the constitution of Peregrine Wines Ltd. Section 149 of the Companies Act 1993, which is discussed in the section 4, is also applicable in this case. Associate Judge Matthews at [14] noted: It is common ground between counsel that s 149 applies to the transaction between the trustees and PEL with the result that a transfer of the trustees’ shares to PEL must be at fair value. Further, if it is at a price more than fair value, the excess is recoverable by PEL and that if it is at less than fair value the trustees may require payment of the difference.

28 *Hay v Peregrine Estate Ltd* [2016] NZHC 2097 at [15].

29 *Hay v Peregrine Estate Ltd* [2016] NZHC 2097 at [21].

30 *Hay v Peregrine Estate Ltd* [2016] NZHC 2097 at [24].

31 *Hay v Peregrine Estate Ltd* [2016] NZHC 2097 at [70].

32 *Peregrine Estate Ltd v Hay* [2017] NZCA 496, [2018] 2 NZLR 345 at [22].

33 The italicised word “*is*” does not appear in the constitution and was italicised by the Court for emphasis.

34 *Peregrine Estate Ltd v Hay* [2017] NZCA 496, [2018] 2 NZLR 345 at [38].

35 *Peregrine Estate Ltd v Hay* [2017] NZCA 496, [2018] 2 NZLR 345 at [45].



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that this required consideration of what the buyer gains and what the seller gives up, with an equitable sharing of gains and losses to both parties.

The Court of Appeal also found that the independent expert was entitled to take legal advice from Chapman Tripp regarding the minority interest discount issue. In any event, the Court considered that “[t]he decision she ultimately arrived at not to apply a minority discount was plainly hers”.<sup>36</sup>

### **4.3 Summary of a Constitution’s and an Expert’s Fair Value**

In summary, the *Glaister* case indicates that normally, a minority interest discount would apply in arriving at the fair value of minority shares. However, the context of the share valuation can change this such as when fair value has a special meaning in a constitution. In the *Glaister* case, the constitution specified an arithmetic formula for determining fair value. Hence, the valuation was on a pro rata basis, that is, without a minority interest discount.

In the *Peregrine* case, both the High Court and the Court of Appeal were of the opinion that the parties were bound by the constitution, which did not contain a specific arithmetic formula, and that an independent expert – not the court – was to determine the fair value. The independent expert in *Peregrine* decided to assess fair value on a pro rata basis, that is, without a minority interest discount, and the Courts were not prepared to second-guess that assessment.

### **4.4 Overriding a Constitution’s and an Expert’s Assessment of Fair Value**

It is important to note that a valuation provision in a constitution or contract, as discussed in sections 4.1 and 4.2 above, may not be determinative where s 149 of the Companies Act applies. Section 149 applies where the share transfer in question involves a transfer of shares from or to a director of the company who possesses non-public information that is material to the assessment of value. In such a situation, any agreed valuation mechanism will be set aside in favour of a statutory assessment of “fair value”.

If s 149 applies, the statutory assessment of fair value will trump any valuation provision in a constitution or contract, or even a price specifically agreed between the parties.<sup>37</sup> As Asher J noted in *Fong v Wong* “[i]t is clear that an express term as to value in an agreement must make way for the application of a fair value in terms of s 149.”<sup>38</sup> Consistently with the approach of Asher J in *Fong v Wong*, the Court of Appeal in *Peregrine* accepted that if s 149 applied, fair value under the constitution might *not* necessarily be the same thing as fair value under s 149.<sup>39</sup>

We now turn to section 5 of the paper that examines s 149.

## **5 SECTION 149 OF THE COMPANIES ACT 1993**

Section 149 of the Companies Act 1993 provides for restrictions on share dealing by directors who hold price sensitive, non-public information. The section requires directors to acquire shares at “not less than fair value” or dispose of them at “not more than fair value”. Failure to comply with s 149 imposes a liability

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<sup>36</sup> *Peregrine Estate Ltd v Hay* [2017] NZCA 496, [2018] 2 NZLR 345 at [49].

<sup>37</sup> *Thexton v Thexton* [2002] 1 NZLR 780 (CA) at [16].

<sup>38</sup> *Fong v Wong* HC Auckland CIV-2008-404-5547, 4 December 2008 at [31].

<sup>39</sup> *Peregrine Estate Ltd v Hay* [2017] NZCA 496, [2018] 2 NZLR 345 at [53]. *Peregrine* did argue that s 149 did in fact apply. However, the Court of Appeal said that this issue had to be decided in separate proceedings.

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on the directors to the other party for the difference between the fair value and the price paid for the shares acquired or the price received for the shares sold.

In closely held companies, s 149 arises commonly in relation to share transfers where directors personally trade shares in the company. It also arises where directors deal in shares in their capacity as trustees of a family trust. In *Fong v Wong* the Supreme Court described the argument that s 149 did not apply to transactions where directors were acquiring shares in the capacity of a trustee as “unsustainable” as this “would allow the obvious purpose of the section to be subverted by the use of a trust associated with a director”.<sup>40</sup>

The legislative purpose behind s 149 is to ensure that directors engaging in share dealing do not take advantage of the other party where the director is in possession of non-publicly available information that is material to the assessment of price. However, that still begs the question as to whether the assessment of fair value under s 149 should be made on the same basis as an assessment of fair value in other contexts and whether the assessment should provide for a minority discount.

### 5.1 Consensual versus Non-Consensual Sale of Shares

The first important point to note is that s 149 applies where the sale and purchase is consensual and not necessarily prejudicial to a party to the transaction. In our view, there is more scope in a consensual sale transaction to argue that a minority discount should apply. The highest value that could be realised for such interests in an arm’s length transaction would have included such a discount.

Contrast this situation under s 149 with situations where a shareholder exits the shareholding involuntarily. That could be the case, for example, where a sale of shares occurs under ss 110 or 118. Here, a minority shareholder has voted against certain important matters and so they have minority buy-out rights. A shareholder might also exit involuntarily if the sale of shares is ordered by the court under s 174 because of oppressive or unfairly prejudicial conduct. In these situations (which are discussed further in sections 6 and 7 below), the shareholder exit is driven by significant conduct that adversely affects the shareholder and it would be inappropriate to apply a minority discount.

The voluntary nature of a sale under s 149 makes the application of a minority discount more likely. However, such a discount may still not be applicable in the situations we discuss next.

### 5.2 No Minority Discount for Fair Value Under s 149

In a consensual sale under s 149, an assessment of fair value might well include a minority discount. The Supreme Court in *Fong v Wong* specifically confirmed that proposition: “A fair value will sometimes include a discount for minority interest. It all depends on the circumstances.”<sup>41</sup>

However, there are at least two situations where the cases suggest that an assessment of fair value under s 149 will *not* include a minority discount. The first involves a closely held company similar to a partnership

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40 *Fong v Wong* [2010] NZSC 120 at [2]. See also *Fong v Wong* HC Auckland CIV-2008-404-5547, 4 December 2008 at [28] and *Holmes v Kiriwai Consultants Ltd* [2015] NZCA 149 at [26]. Compare *Peregrine Estate Ltd v Hay* [2017] NZCA 496, [2018] 2 NZLR 345 at [54]. Professor S Watson in “*Coleman v Myers* under the Companies Act 1993” (1995) 1 NZBLQ 168 at 172 has noted that s 149 does not capture share dealing by companies related to the director. The clear words of s 149 specifically refer to a director acquiring or disposing of shares. Accordingly, it would seem that s 149 does not apply where a director of Company A has a controlling interest in another company (Company B) that buys or sells shares in Company A.

41 *Fong v Wong* [2010] NZSC 152, (2010) 20 PRNZ 250 at [6].

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where the shareholders are also involved in management, and the shareholders have fallen out. In such a situation, the cases suggest that the approach to assessment of fair value is likely to be similar to that taken in a s 174 case involving unfairly prejudicial conduct, that is, there will be *no* minority discount.

The second is a situation where there are provisions in a constitution that give a minority shareholder rights that are greater than the rights normally held by a minority.<sup>42</sup> The conferral of such rights may militate against the application of a minority discount.<sup>43</sup> This was the driver for Keane J's decision that a minority discount would *not* apply in *Fong v Wong*.

In that case, the company constitution required a 75 per cent majority for not just special resolutions but also ordinary resolutions (which would normally only require a bare majority to pass) and for the appointment and removal of directors (which again would normally only require the vote of a bare majority of shareholders). Keane J described this conferral of significant power on the minority shareholder as the "decisive factor standing in the way of a minority discount". The constitutional provisions meant that the shareholders "enjoyed equality of arms" and this in turn led to the conclusion that the minority shareholding in question had special value, and that this special value was "inconsistent with a minority discount".<sup>44</sup>

A third possible situation to consider is the relevance of a specific direction against the application of a minority discount in the company constitution. In *Kiriwai Consultants Ltd v Holmes* it appears to have been conceded by all parties that the fair value assessment under s 149 should not include a minority discount because there were directions in the constitution that no minority discount apply on a transfer of shares.<sup>45</sup> However, it is not clear to us that such a concession was justified. It is inconsistent with the clear authority in cases such as *Thexton v Thexton* that if s 149 applies then the fair value assessment under s 149 takes priority over, and in fact overrides, any contractually agreed valuation methodology.

A further important general proposition clearly established by the case law under s 149 is that it is not enough to establish fair value to say that both parties had the same information and willingly agreed the same price.<sup>46</sup> The Court of Appeal decision in *Thexton v Thexton* said that the disclosure of the price sensitive information to the other party does not affect the application of s 149 and the director's agreement with the other party for anything other than fair value has no effect.

We turn now to discuss the decision in *Fong v Wong* which provides some specific guidance on the meaning of "fair value" including in the context of whether a minority discount should apply.

### **5.3 Overriding an Agreement to Transact a Minority Interest at a Discount**

In *Fong v Wong*,<sup>47</sup> the plaintiffs owned 68 per cent of the shares and the defendants owned the minority 32 per cent. The plaintiffs applied for summary judgment against the defendants to perform their obligations under a deed of dissolution which provided for "the shares to be valued at fair market value", which all

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42 In that sense, the shareholding might not even be truly considered a minority shareholding at all if the definition in section 2 above is taken, namely a definition that depends on whether the shareholding lacks the ability to exert control or influence over corporate decisions.

43 *Fong v Wong* [2010] NZSC 152, (2010) 20 PRNZ 250 at [9] and n 10.

44 *Wong v Fong* HC Auckland CIV-2009-404-2469, 16 December 2009 at [56]. See also at [37]–[43].

45 *Kiriwai Consultants Ltd v Holmes* [2014] NZHC 512 at [35]. This point was not discussed further when the case went on appeal to the Court of Appeal.

46 *Thexton v Thexton* [2002] 1 NZLR 780 (CA) at [16]; *Fong v Wong* HC Auckland CIV-2008-404-5547, 4 December 2008 at [23]–[24] and [30]–[31].

47 *Fong v Wong* HC Auckland CIV-2008-404-5547, 4 December 2008.

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experts involved in the case accepted would involve a minority interest discount. Notwithstanding the deed, the defendants argued that s 149 required the plaintiffs to pay fair value without a minority interest discount. The defendants argued for the requirement for valuation at fair market value to be set aside because of the provisions of s 149.

Asher J considered the four matters that need to be established before s 149 is triggered. First, the vendor or acquirer of the shares must be a director of the company. Second, they must have information in their capacity as a director or employee of the company. Third, that information would not otherwise be available to them. Fourthly, the information must be material in assessing the value of the shares. He was of the view that these four conditions characterised the parties in the case. Asher J decided that the deed's requirement for a valuation at fair market value was in breach of s 149, and the plaintiffs' claim for summary judgment failed.

Further, he held that it did not matter that the plaintiff, who was a director, was not acquiring shares personally but in his capacity as a trustee. To allow such an exemption would be

“defeating the clear intention behind the section which is to prevent the exploitation of insider knowledge. ... The fact that the named purchaser is a director is sufficient to bring the situation within the words of s 149.”<sup>48</sup>

As indicated above, the Supreme Court subsequently approved Asher J's view in this regard and in fact stated that it regarded the argument to the contrary as being “unsustainable”.<sup>49</sup>

In spite of Fong and Chong's failure to obtain summary judgement against Wong and Fong, the latter, nevertheless, transferred their minority shares to Fong and Chong at fair market value based on the deed of dissolution. Wong and Fong then brought an action against Fong and Chong in the High Court.<sup>50</sup> Now the plaintiffs, Wong and Fong were relying on s 149 to recover the amount they claimed Fong and Chong, now the defendants, had underpaid.

The plaintiffs argued that the price they received from the defendants was fair market value (reduced by a 30 per cent minority interest discount), whereas they should have received fair value (without the discount), in accordance with s 149 and the company's constitution.

Keane J concurred with Asher J that the share exchange was an exchange subject to s 149 and had to be at fair value. The plaintiffs were entitled to their claim for the difference between fair value and fair market value, that is, the discount amount.

The matter then went to the Court of Appeal and the Supreme Court. These appeals focussed on the meaning of fair value under s 149. That is, whether fair value is determined by a professional valuation standard or by a statutory test.

The share valuation experts, PwC and Mr Hagen,<sup>51</sup> concurred that fair market value, as assessed by PwC, did not represent fair value. The Court of Appeal noted that PwC indicated:<sup>52</sup>

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48 *Fong v Wong* HC Auckland CIV-2008-404-5547, 4 December 2008 at [28].

49 *Fong v Wong* [2010] NZSC 120 at [2].

50 *Wong v Fong* HC Auckland CIV-2009-404-2469, 16 December 2009.

51 *Wong v Fong* HC Auckland CIV-2009-404-2469, 16 December 2009.

52 *Fong v Wong* [2010] NZCA 301 at [12].

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[w]hile we understand that one of the parties to the Deed now considers ‘fair value’ should be the standard applied, the Deed and our engagement letter are explicit in requiring the standard to be fair market value. Application of the fair value standard is likely to result in different valuation opinions to those expressed in this document.

PwC’s phrase “different valuation opinions” implies the non-application of the minority discount of 30 per cent had they determined fair value.<sup>53</sup>

The other share valuation expert, Mr Hagen said “the ‘fair value’ between the parties ... should not include the 30% minority discount as was applied by PwC.”<sup>54</sup> The distinction between fair market value and fair value was reiterated by the Court of Appeal<sup>55</sup> and the Supreme Court who noted that “the unchallenged” expert evidence from Mr Hagen was that fair value was something different from fair market value.<sup>56</sup>

So, is fair value a professional valuation standard that is determined and used for establishing value by chartered accountants, investment bankers and professional valuers, or is fair value a statutory or assessment test that is determined by the courts?

In the Court of Appeal, counsel for the applicants argued “it would be wrong to stipulate that a specific standard of ‘fair value’ should be applied”. He went on to suggest that “the Court should stand back and assess whether, having regard to all the circumstances and the knowledge of each party about the affairs of the relevant company, the outcome was fair.”<sup>57</sup> While O’Regan J saw “some attraction in that argument”,<sup>58</sup> he was of the view that PwC’s fair market value (a professional valuation standard) could not be fair value (the statutory test) in this case when “the unchallenged expert evidence from both experts indicated that this was not so.”<sup>59</sup>

The Supreme Court in refusing to recall an earlier judgment declining leave for a substantive appeal to the Supreme Court, held that a discount for minority interest would *not* on the particular facts result in a fair value.

The Supreme Court acknowledged, “[a] fair value will sometimes include a discount for minority interest. It all depends on the circumstances”. However, the Court referred to case law relevant to a case of unfairly prejudicial conduct under s 174, stating that in a case “where the shareholders in a closely held quasi-partnership company have fallen out”, and where one party has excluded the other from management, then fair value would not include a minority discount. In such circumstances “such a discount would usually not be fair as between vendor and purchaser in terms of: (a) the alternative (ie, winding up);<sup>60</sup> (b) what each gains and gives up on the transaction; and (c) the quasi-partnership nature of the underlying relationship”.<sup>61</sup>

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53 In *Wong v Fong* HC Auckland CIV-2009-404-2469, 16 December 2009 at [20], Keane J noted that “PwC, in its final valuation dated 4 July 2008, adhered to the opinion that the discounts were appropriate to a ‘fair market value’. PwC did say that, had it been asked to assess a ‘fair value’ for the two shareholdings, the result would likely have differed”.

54 *Fong v Wong* [2010] NZCA 301 at [16].

55 *Fong v Wong* [2010] NZCA 301 at [36].

56 *Fong v Wong* [2010] NZSC 120 at [4].

57 *Fong v Wong* [2010] NZCA 301 at [35].

58 *Fong v Wong* [2010] NZCA 301 at [35].

59 *Fong v Wong* [2010] NZCA 301 at [35].

60 In a winding up of the company, a shareholder would receive their pro rata share of the net proceeds from liquidating the company.

61 *Fong v Wong* [2010] NZSC 152, (2010) 20 PRNZ 250 at [5].

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The Court then went on to say that on the facts of the particular case “given the family and quasi-partnership nature of the company and the associated provisions in the company’s constitution, there was no obvious basis for a discount”.<sup>62</sup>

The reference in this passage to the constitution was in particular a reference to the fact that the minority shareholder had rights under the Constitution that were “broadly equivalent to those of a 50 per cent shareholder”.<sup>63</sup>

### 5.4 Summary of s 149 Case Law

In summary, the ultimate test in determining fair value is whether the value is “fair as between vendor and purchaser.”<sup>64</sup> This principle aligns with PwC’s view that fair value “requires an assessment of what the buyer gains and what the seller gives up, and an equitable sharing of gains and losses”<sup>65</sup> and that of Mr Hagen that fair value “required the valuer to ensure that the ‘value’ itself was fair as between vendor and purchaser. That required the valuer to consider both what the vendor gave up and what the purchaser obtained.”<sup>66</sup> A key consideration is the context of the transaction – whether it is voluntary and consensual or prejudicial and precipitated.

The case law suggests there are two situations where the assessment of fair value under s 149 will *not* include a minority discount. The first involves a closely held company similar to a partnership where the shareholders are also involved in management, and the shareholders have fallen out. The second is a situation where there are provisions in a constitution that give a minority shareholder rights that are greater than the rights normally held by a minority.

## 6 SECTION 112 OF THE COMPANIES ACT 1993

Sections 110 and 118 of the Companies Act 1993 provide for a shareholder requiring a company to purchase shares. There are four situations where these statutory “minority buyout rights” apply. The buyout rights occur where:

- (a) A shareholder votes against a special resolution authorising a change to the company constitution and that change imposes or removes a restriction on the activities of the company. For example, the company constitution says that the company may only trade in the field of tourism and a special resolution removes that restriction and allows the company to trade in any field of commerce.
- (b) A shareholder votes against a special resolution approving a major transaction such as the acquisition or sale of an asset that is valued at more than half the value of all the company’s assets.
- (c) A shareholder votes against a special resolution approving an amalgamation under s 221.
- (d) A shareholder votes against a special resolution of an interest group under s 117 that approved the taking of action that affects the rights attaching to shares, including voting rights and rights to distributions.

If minority buyout rights apply, then s 112(2) prescribes how a “fair and reasonable price” is calculated. The formula is:

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62 *Fong v Wong* [2010] NZSC 152, (2010) 20 PRNZ 250 at [9].

63 *Fong v Wong* [2010] NZSC 152, (2010) 20 PRNZ 250 at [9] and n 10.

64 *Fong v Wong* [2010] NZSC 152, (2010) 20 PRNZ 250 at [8].

65 *Fong v Wong* [2010] NZCA 301 at [12].

66 *Wong v Fong* HC Auckland CIV-2009-404-2469, 16 December 2009 at [49].

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- first, to compute the fair and reasonable price of the total shares in each class (the “class value”);
- secondly, to adjust for any positive or negative fluctuation that may have arisen because of the resolution requiring the company to purchase the shares (referred to as the “adjusted class value”); and
- thirdly, to allocate the adjusted class value in proportion to the number of shares held by the shareholder. The calculation is a pro-rata value, and the section is clear that there is *no* discount for a minority interest.

Section 112(3) allows a different methodology only if the above prescription is “clearly unfair” to the shareholder or to the company.

The minority buyout right provisions in the Companies Act are modelled on the concept of “appraisal rights” in North America.<sup>67</sup> The US courts have largely rejected the application of minority discounts in assessing fair value under appraisal right procedures. Instead, they have adopted a “pro rata value doctrine” under which the fair value of a share is equal to a pro rata or proportionate interest in the value of the entire company.<sup>68</sup>

A leading US court decision from about the same time as the Law Commission report recommending the New Zealand minority buyout procedure was *Cavalier Oil Corp v Harnett*.<sup>69</sup> That case considered a shareholder who had dissented from a “cash-out merger”, requiring the shareholder to sell his shares in the company. This gave the shareholder “appraisal rights” under Delaware law, entitling him to an appraisal of the fair value of his shares. The Supreme Court of Delaware held that to apply a minority discount was contrary to the nature of the appraisal remedy. The Court said that applying a minority discount would unfairly enrich the majority shareholders who would reap a windfall from the cashing out of a dissenting shareholder.<sup>70</sup>

The valuation formula for minority buyout rights in s 112(2) reflects a similar philosophy to that taken by the Supreme Court of Delaware in the *Cavalier Oil Corp* case. That is, where a dissenting shareholder exits a company, a pro rata interest in the value of the company (without the application of a minority discount) should normally apply.

Minority buyout rights can also be seen as analogous to court ordered buyout rights under s 174 (discussed below), as in both cases the exit from the company has been caused by some action of the company that the minority is unhappy with.

In our view, it seems clear that a “fair and reasonable price” under s 112(2) is assessed in the same way as a “fair price” or “fair value” for a buyout order under s 174. In either case, in our view, the assessment is on a pro rata basis without any minority discount.

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67 Law Commission *Company Law: Reform and Restatement* (NZLC R9, 1989) at [202]–[207] and [470]–[476].

68 John C Coates IV “*Fair Value*” as an Avoidable Rule of Corporate Law: *Minority Discounts in Conflict Transactions* (1999) 147 U Pa L Rev 1251 at 1255 and 1266–1287.

69 *Cavalier Oil Corp v Harnett* 564 A 2d 1137 (Del 1989).

70 *Cavalier Oil Corp v Harnett* 564 A 2d 1137 (Del 1989) at 1144–1145.

### 7 SECTION 174 OF THE COMPANIES ACT 1993

Section 174 allows a current or former shareholder, who believes they have been unfairly discriminated against or unfairly prejudiced by the way the company's affairs are conducted, to apply to the court for relief.<sup>71</sup>

The court's powers are set out in s 174(2). They include an order for the company or any other person to buy out the prejudiced shareholder's shares, paying compensation to the prejudiced shareholder, appointing a receiver, liquidating the company, and other orders. The Act requires the aggrieved shareholder to demonstrate that the company's conduct is "oppressive, unfairly discriminatory, or unfairly prejudicial" to him or her.

While s 174 can apply to listed companies,<sup>72</sup> most of the prejudiced shareholder cases relate to closely held family companies. Proving unfair discrimination or unfair prejudice is more difficult for a listed company and, in any event, the prejudiced shareholder in a listed company can sell their shares in the open market at market value.

For a closely held family business, if the court orders the company or any other person to acquire the aggrieved shareholder's shares, the shares must be valued. Section 174 is silent on how they are to be valued. The Court of Appeal in *Yovich & Sons Ltd v Yovich* confirmed that the buyout price assessed under s 174 must be a "fair price".<sup>73</sup>

The generally accepted view of the courts is that a fair price or fair value assessment in a buyout order under the section will *not* normally provide for a minority discount. The Court of Appeal in *Yovich* traversed the case law and emphasised the difference between a fair price under s 174 (which would *not* include a minority discount) and a market valuation (which would):<sup>74</sup>

These authorities clearly demonstrate the general reluctance of the Courts of the various jurisdictions to any discounting [of] the proportionate value of a minority shareholding in the case of a buyout order under s 174. On the other hand the restricted position of a minority shareholder is readily acknowledged by the Courts when the Court is required to set a market valuation for such a holding (*Holt v Holt* [1987] 1 NZLR 85 (CA) at 90 per Cooke P). The reason for the difference in approach is the overriding criterion of fairness, which the Courts see as an implicit requirement in fixing the price.

The Court of Appeal also noted an important policy reason for not applying a minority discount in a case of unfairly prejudicial conduct. To do so might in fact reward and incentivise such conduct. The Court stated:<sup>75</sup>

To apply a discount to the proportionate value of a minority holding would of course often be to reduce the price for a parcel of shares on account of the weakness in the shareholder's position which the unfairly prejudicial conduct exploited. It would indeed provide continuing incentives for such conduct.

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71 Section 175 of the Companies Act 1993 lists certain types of conduct that are deemed to be prejudicial and cover certain actions in relation to, inter alia, pre-emptive rights, consideration for the issue of shares, dividends, special financial assistance and major transactions.

72 *Latimer Holdings Ltd v SEA Holdings New Zealand Ltd* [2005] 2 NZLR 328 (CA) at [98]–[111].

73 *M Yovich & Sons Ltd v Yovich* (2001) 9 NZCLC 262,490 (CA) at [35].

74 *M Yovich & Sons Ltd v Yovich* (2001) 9 NZCLC 262,490 (CA) at [55]. Note that the decision in *Holt v Holt* discussed in this quote canvassed different issues related to control, managerial influence, benefits and differential rights associated with an A share in a farm partnership.

75 *M Yovich & Sons Ltd v Yovich* (2001) 9 NZCLC 262,490 (CA) at [56].



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However, the general approach under s 174 of applying *no* minority discount has been applied by the Court of Appeal to a situation where the party to be bought out was the party held to be the one guilty of unfairly prejudicial conduct. This occurred in *Sturgess v Dunphy* where the Court nevertheless held that the buyout order should proceed on the basis that there was *no* discount applied for minority interest (or premium for control).<sup>76</sup> As indicated below, however, the Court in *Sturgess* may have been influenced by the terms of the shareholders' agreement that provided for a valuation formula excluding the application of a minority discount or control premium.

The situation in *Sturgess v Dunphy* was one in which the parties had essentially fallen out and a court imposed an order facilitating a parting of the ways.<sup>77</sup> In such a situation, it seems that the courts will regard it as fair that the parting of the ways does not involve the outgoing shareholder being required to accept a minority discount.

In this case, the three shareholders in Greymouth Petroleum Holdings Limited were Sturgess 13.856 per cent, Dunphy 52.144 per cent, and Masfen 34 per cent. The Court of Appeal described their business relationship "as a joint venture or quasi-partnership among three men. Its governing documents assume they would work closely together. ... The agreements assume a high level of mutual commitment to these objectives".<sup>78</sup> The Court found that Mr Sturgess breached both the letter and spirit of the shareholder agreement and that his conduct was oppressive and unfairly prejudicial toward the other shareholders.

In terms of relief, the Court said:<sup>79</sup>

The most common remedy is a buyout order, presumably because the cases usually involve tightly held companies or quasi-partnerships in which the members can no longer do business together. When fixing the price the court will adopt a valuation methodology designed to achieve fair market value, which is normally defined as the price that an informed buyer would pay. It assumes no discount for minority status.

At the very next paragraph, the Court went on to say that "The parties here agree that fair value is the appropriate measure". The Court appeared to use the terms "fair market value" and "fair value" interchangeably. However, this reflects the fact that the valuation methodology in the shareholders' agreement for the company also used both terms. The shareholders' agreement also suggested that the valuation of an exiting shareholder's interest should be based on "its proportion of the fair market value of all the shares in the company, with neither discount nor premium for control".<sup>80</sup>

In summary, the buyout remedy in the prejudiced shareholders provision of the Companies Act requires the transfer of shares to take place at fair value where the price for the exiting shareholder's interest is likely to be assessed as the pro rata portion of the total value, without a minority interest discount or a majority control premium.

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<sup>76</sup> *Sturgess v Dunphy* [2014] NZCA 266 at [148].

<sup>77</sup> *Sturgess v Dunphy* [2014] NZCA 266.

<sup>78</sup> *Sturgess v Dunphy* [2014] NZCA 266 at [142].

<sup>79</sup> *Sturgess v Dunphy* [2014] NZCA 266 at [148].

<sup>80</sup> *Sturgess v Dunphy* [2014] NZCA 266 at [150].

## **8 GUIDELINES FOR ASSESSING FAIR VALUE IN THE CONTEXT OF THE SALE OF A MINORITY SHAREHOLDING**

Fair value tests the fairness of what one party is giving up and what the other is getting. In effect, fair value is a “reasonableness test”, which assesses fairness in a specific context, on a specified date involving specified parties. In some cases, it is possible that given the parties involved and their relative positions that a fair market value is indeed a fair value, but this is a specific case of a fair value test. What is of relevance is the context and circumstances of the transaction and exchange.

We provide below our guidelines for assessing fair value of a minority shareholding and, in particular, where a minority discount ought to apply.

### **8.1 The Positions of the Parties Involved**

Are the parties existing shareholders in the company or are they dealing at an arm’s length basis in relation to a listed security? If the latter, a fair market value should yield the same value as a fair value. In this case applying a minority discount to a pro rata value may be appropriate if the acquirer is acquiring a minority interest and there is evidence of differential rights attached to such an equity interest.

However, after the transaction both parties would be shareholders in the same company. Thereafter, the value associated with any transfer of interests among the shareholders would depend on whether the company is listed or unlisted. In a listed company and if the shares are liquid, a fair value would be the listed price as that would be fair recognition of what one is giving up and the other is getting, and neither party would be able to get a higher realisation or pay a lower price.

In an unlisted company, the situation is different because the shares transacted are among specified shareholders. The maximum value that a seller would be able to realise in such a closed market would be the pro rata value applicable to an equity share in that category of shares. Similarly, the maximum value that the buyer would be willing to pay would be the pro rata value on the basis that this would represent the value of the benefits that a controlling shareholder could derive from that company.

### **8.2 Acquisition of shares at a discount**

The cases, in particular *Glaister* and *Fong v Wong*, suggest that the starting point is that fair value may require the application of a minority discount.

However, if fair value is being applied under a contractual or constitutional provision then the context and specification of the document will be key, as will its application to the specific context in which the valuation is being undertaken. In *Glaister*, the particular constitutional provision was expressed in mathematical terms and the Court held that this excluded room for the application of a minority discount.

Alternatively, if a constitution or contract provides for fair value but without providing guidance as to whether there should be a minority discount, or if s 149 applies so that fair value must be paid under that section, then whether a minority discount will apply depends on certain factors.

In particular, these factors are whether (a) the company is a closely held company which might be considered to be a quasi-partnership, (b) the minority shareholder has been excluded from management or subject to some other form of prejudicial conduct, and (c) whether the minority shareholder has greater than usual rights under the company’s constitution. Each of those factors would tend to suggest that a minority discount should not apply.

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In the Court of Appeal hearing of *Fong v Wong*, Mr Hagen, a share valuation expert, commented:<sup>81</sup>

I am not of the view that the standard of “fair value”, of itself, bars the application of a discount for minority shareholdings. For example, if there were a situation where a shareholder had acquired a minority interest which had a minority discount applied to it then on sale, under the “fair value” standard, it would seem quite reasonable that a minority discount should also apply.

We do not concur with Mr Hagen’s “discount-in discount-out” approach. That is, we are not of the view that acquisition of shares at a discount means that, after such an acquisition, the shares would sell at a discount. The context and relative positions would have changed after the initial acquisition and, therefore, fairness in this context would have changed.

For example, an incoming shareholder may have acquired a minority parcel of shares at a discount on an arm’s length basis. Following the acquisition, the minority shareholder becomes a director of the company, possesses information, as a director or employee, and the information is relevant to the assessment of the value of the shares in the company.<sup>82</sup> When the minority shareholder sells the minority shares later, a fair value under s 149 would apply.

Whether a minority discount applies in such a situation will depend on whether the three factors discussed above apply. The context and relative position may have changed from an outsider acquiring a minority parcel of shares in the company to a shareholder who is now involved with the strategic direction of the company and possibly running the business. In this scenario, “discount-in does not require discount-out”.

Finally, if the determination of “fair value” is under s 174 or if it is necessary to consider what is a “fair and reasonable price” in the case of minority buyout rights under s 112 then no minority discount will apply.

### **8.3 Rights and Powers Associated with Category of Shares**

The decision of Keane J in *Fong v Wong* and the view of the Supreme Court in that case both examine the conferral on a shareholder of greater than usual powers, for example, to block ordinary shareholder resolutions or the appointment and removal of directors. Where these powers exist, no minority discount should apply in determining fair value.

### **8.4 Valuation Methods**

In the United States, the courts have held that proof of fair value does not have to follow any particular method of valuation and can be “by any techniques or methods which are generally considered acceptable in the financial community”.<sup>83</sup> Assessment of a fair price should include “all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock.”<sup>84</sup>

However, if the particular context suggests that fair value should not involve a minority discount, then care should be taken that the choice of valuation methodology is consistent with that. Coates points out that

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81 *Fong v Wong* [2010] NZCA 301 at [16].

82 *Fong v Wong* HC Auckland CIV-2008-404-5547, 4 December 2008 at [25].

83 *Weinberger v UOP, Inc* 457 A 2d 701 (Del 1983) at 713.

84 *Weinberger v UOP, Inc* 457 A 2d 701 (Del 1983) at 711.

some methodologies may involve an implicit minority discount.<sup>85</sup> This might occur, for example, where the actual trading prices of shares of comparable companies are used to proxy for the fair value of the shares of the company being valued. Such trading prices will likely already reflect a minority discount in which case the value produced by the valuation will also include an implicit discount.

### 8.5 Allowing for Future Uncertainty

The courts have held that a fair value assessment should take into account the risk that expected future outcomes may not occur. These risks must have a material impact on the value and there must be a proper evidential foundation to support a reasonable probability or certainty of occurrence.

In *Holmes v Kiriwai Consultants Ltd* a key part of the value of the shares in HVL was the expected sale by the company of an HVL subsidiary to the Port of Tauranga for \$34 million.<sup>86</sup> However, at the time that fair value had to be assessed, 15 November 2012, there was no binding sale contract in place. The Court of Appeal held that the likelihood of the sale proceeding was sufficiently high that it was a material factor that should have been taken into account in assessing fair value. However, the Court also recognised that as at 15 November 2012, the transaction was not certain and there were contingencies. It was still possible that the deal might not go ahead or that it might not go ahead at the figure of \$34 million.

The view of the majority of the Court of Appeal was that an appropriate discount reflecting those contingencies was no greater than five per cent (French J would have applied a higher discount of 15 per cent). The expert determination of the value to the company of the sale of its subsidiary company was therefore discounted by five per cent, and that discounted value then taken into account in arriving at a figure for the fair value of the shares in the company.<sup>87</sup>

In *Cooper-Davies Trustees Number 6 Ltd v Cooper Trustees Number 11 Ltd* a key aspect of the assessment of the fair value of the shares in the company Madras Street 323 Ltd was the likely insurance value of a commercial building owned by the company.<sup>88</sup> The Christchurch earthquakes had damaged the building. At the relevant time for assessment of the fair value of the shares in the company (3 May 2011), the company's insurer, Zurich, had not yet settled with the company. In October 2011, Zurich made a payment to the company of \$6,360,497 that represented the full replacement sum assured under a material damage insurance policy (less a deductible) together with a payment for loss of income under a business interruption policy.

In the High Court, Gendall J considered there were a number of risk elements in existence in May 2011 that meant there was no absolute certainty that the final insurance payout – later received – would eventuate. The judge identified a number of risk factors and concluded that they warranted a 50 per cent discount in arriving at an assessment of the fair value of the shares in the company.

On appeal, the Court of Appeal agreed that any risk factors prevailing at the relevant date should be taken into account.<sup>89</sup> However, the Court of Appeal considered that many of the risk factors taken into account by Gendall J should not have been taken into account due to a lack of evidential foundation. The Court of Appeal accepted only two of the risk factors taken into account by Gendall J. These were first, the sale value

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85 John C Coates IV "Fair Value" as an Avoidable Rule of Corporate Law: *Minority Discounts in Conflict Transactions* (1999) 147 U Pa L Rev 1251 at 1264–1265 and see the consequential criticism of the US court decisions at 1268–1287.

86 *Holmes v Kiriwai Consultants Ltd* [2015] NZCA 149.

87 *Holmes v Kiriwai Consultants Ltd* [2015] NZCA 149 at [49]–[50].

88 *Cooper-Davies Trustees Number 6 Ltd v Cooper Trustees Number 11 Ltd* [2015] NZCA 197.

89 *Cooper-Davies Trustees Number 6 Ltd v Cooper Trustees Number 11 Ltd* [2015] NZCA 197 at [35].

## *Fair Value of Minority Shares in a Closely Held Company*

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of the bare land was unknown and secondly, the possible future risks for the property as a whole because it was in the Christchurch red zone. The Court of Appeal agreed those risks were material and had a strong evidential foundation. It refused to take account of the other risk factors and held that the appropriate overall discount should be 15 per cent, not 50 per cent.

### **9 SUMMARY AND CONCLUSION**

This article examines the notion of fair value for minority shares in a closely held company. We conclude that fair value is not a single valuation standard or prescriptive calculation method, but is a contextual assessment. The context influences whether a discount ought to apply in determining the fair value for minority shares.

The High Court in *Glaister v Amalgamated Dairies Ltd* and the Supreme Court in *Fong v Wong* set out the baseline position that fair value may include a discount for minority interest. This reference point is the well-established principle that the discount reflects the lack of the power or liquidity available to minority shareholders.

However, there are contractual and statutory share price fixing provisions relevant to whether a discount applies when determining the fair value for minority shares in a closely held company. These can be summarised as follows:

- (1) A minority discount will not apply where the company's constitution prescribes a formula that specifies the fair value as the pro rata share of the total equity value. The decision in *Glaister v Amalgamated Dairies Ltd* makes it clear that where a company's constitution specifies a fair value in this manner, valuers cannot use their judgment and apply a discount. The context is the special meaning given to fair value in the constitution.
- (2) An expert will have considerable discretion in assessing fair value where the company's constitution provides for an expert to determine fair value without specific guidance on how to do so, as in *Hay v Peregrine Estate Ltd*. In this context, a court will not interfere if the expert decides not to apply a discount. That discretion will likely also extend to the situation where the expert does apply a minority discount.
- (3) Where s 149 applies, a fair value determination under s 149 will trump valuation provisions in a constitution or contract that specify some other value, such as an agreed value in *Thexton v Thexton* and a fair market value in *Fong v Wong*. The context is the s 149 restrictions on share dealing by directors who hold price sensitive, non-public information.
- (4) A s 149 fair value assessment may or may not apply a minority discount based on the circumstances involved. A minority discount may apply here where the transaction appears to be an open market consensual transaction. However, a minority discount is less likely to apply where the company is a closely held company and the shareholders have fallen out, or where the company constitution gives a minority shareholder greater than usual rights.
- (5) Where minority buyout rights apply, s 112(2) prescribes a "fair and reasonable price" as a pro-rata value. The section is clear that there is *no* discount for a minority interest unless the value so determined is "clearly unfair" to the shareholder or the company. The context is the Companies Act protection afforded to minority shareholders where the majority shareholders have taken significant steps that the minority disagrees with.

- (6) Where a current or former shareholder is unfairly prejudiced, s 174 allows them to apply to the court for relief. The court may order the company or any other person to acquire the aggrieved shareholder's shares. Section 174 is silent on how the shares are valued, and the decision in *Yovich & Sons Ltd v Yovich* prescribes a "fair price." The "fair price" is a pro rata value without a discount; otherwise, the discount would provide an incentive for the oppressive and discriminatory conduct.
- (7) The courts will likely allow considerable discretion to a valuer in the choice of a valuation methodology when assessing fair value. However, if fair value in a particular context does not allow for a minority discount, then the valuation methodology cannot explicitly or implicitly provide for a discount. A methodology that is based at least partially on evidence of market prices risks infringing this principle, as market prices will often implicitly incorporate a minority discount. Therefore, a valuer must be careful in applying comparable company or acquisition data particularly when such data are from publicly listed companies.

In summary, fair value as the term suggests has to be equitable to the acquirer and the vendor, recognising what the seller gives up in value and what the buyer receives through the share acquisition. Whether this would be a pro rata share without a discount will depend on the particular context.

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