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LL.M. – Minor Dissertation

Topic: 'Determining 'fair value' in terms of s164 of the Companies Act 71 of 2008, using an analysis of the interpretation of comparative laws in the United Kingdom and the United States.'

Supervisor: Kathy Idensohn

Minor dissertation presented for the approval of Senate in fulfilment of part of the requirements for the LLM degree in approved courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of LLM dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

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My sincere thanks go to my supervisor, Kathy Idensohn.

Chapter 1 - Introduction

1.1 Background

A set method of determination of the fair value of shares is omitted from s164 of the South African Companies Act 71 of 2008 (the **South African Act**), which deals with the appraisal remedies of dissenting shareholders. This dissertation will consider how courts in the United Kingdom and the United States have dealt with the question of what is fair value in the context of oppression remedies and appraisal rights.

1.2 s164 of the Companies Act 71 of 2008

It is necessary to give a brief introduction to s164 of the South African Act in order to contextualise the importance of the determination of fair value. S164 creates a mechanism whereby, in certain prescribed circumstances, a dissenting shareholder is able to demand that the company pay him or her the fair value for all shares that the shareholder holds.[1] It is one of the ways in which minority shareholders are protected under the South African Act.[2] The prescribed circumstances referred to include those where the company in which the shareholder holds shares ('the **company**') has passed resolutions the effect of which would result in the Memorandum of Incorporation being amended to "*materially and adversely alter the preferences, rights, limitations or other terms of a class of shares*"[3], where there will be a disposal of substantially all the assets or undertakings by the company,[4] where a merger or amalgamation involving the company is to take place[5] and where a scheme of arrangement will be entered into.[6] It is beyond the scope of this dissertation to consider the technicalities of invoking this section.

[1] PA Delport (2011) *Henochsberg on the Companies Act 71 of 2008* Durban: LexisNexis at pg 577-582.
[2] Ibid at 577-582.
[3] Companies Act 71 of 2008 at s37(8).
[4] Ibid at s112.
[5] Ibid at s113.
[6] Ibid at s114.

If the dissenting shareholder has made proper demand upon the company, the company must send to the shareholder a written offer to pay an amount considered by the company's directors to be the fair value of the relevant shares, accompanied by a statement showing how that value was determined.[7] The fair value in respect of any shares must be determined as at the date on which, and time immediately before, the company adopted the resolution.[8] A shareholder who has made a demand can either accept the offer[9] or apply to a court to determine a fair value in respect of the relevant shares[10].[11]

1.3 A brief introduction to rights of dissenting shareholders in England and the United States

1.3.1 England

In English law, the comparable remedy to s164 is known as 'share buy-outs'. The English Companies Act[12] (the "**English Act**") provides in s996(2)(e) that a court may, should it find that a company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of its members generally or of some part of its members, or that an actual or proposed act or omission of the company is or would be so prejudicial, make an order for the purchase of the shares of any members of the company by other members or by the company itself and, in the case of a purchase by the company itself, the reduction of the company's capital. Such an order is known as a 'purchase order'. The minority shareholder who claims such an order is referred to as a 'petitioner'. S996 is in all respects identical to s461 of the English Companies Act of 1985, on which the case law to be discussed in this dissertation is predicated.

[7] Ibid at s164 (11).
[8] Ibid at S164 (12).
[9] Ibid at S164(13).
[10] Ibid at S164(14).
[11] PA Delport (*supra* note 1) at pg 581-582.
[12] 2006 Chapter 46.

1.3.2 The United States

Each state in and territory of the United States has its own basic corporate code and, while all states offer appraisal rights for mergers at least, the jurisprudence in the different states is not the same.[13] The Model Business Corporation Act (or more accurately the Revised Model Business Corporation Act)[14] (the "**Model Act**") and the Delaware General Corporation Law[15] (the "**DGCL**") are considered the two templates of corporate law in the United States. Twenty-four states have adopted the Model Act,[16] but the most extensive case law stems from Delaware, as more than half of the listed companies incorporated in the United States are registered in that state,[17] and almost all of the high-profile appraisal claims have involved Delaware-incorporated companies.[18] The Model Act provides for an appraisal remedy in s13.02 and the DGCL does so in s262. However, s13.02 of the Model Act and s262 of the DGCL are quite different remedies and, most importantly, they differ in terms of events that would trigger the appraisal right. Suffice it to say the both create the right of a shareholder to dissent from corporate decisions and obtain payment of the value of his or her shares for 'fair value' in certain circumstances.

1.4 Why it is advisable to appropriate the lessons learnt – similarities and dissimilarities with s164 of the South African Act

The concept of appraisal rights have a long history in the abovementioned jurisdictions and the case law of these jurisdictions may be invaluable to South African courts when the meaning of 'fair value' needs to be determined. The only stark difference between s164 of the South African Act and the comparable sections of the United Kingdom and the United States are that the laws of the latter provide that only the court may make the order for shares to be repurchased – shareholders may not demand a

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[13]DE Wolf (2015) "Crossing State Lines Again—Appraisal Rights Outside of Delaware" *Harvard Law School Forum on Corporate Governance and Financial Regulation*. Available online at: http://corpgov.law.harvard.edu/2015/03/25/crossing-state-lines-again-appraisal-rights-outside-of-delaware/ [Last accessed: 20 April 2015].
[14]Of 2002.
[15]Title 8, Chapter 1 of the Delaware Code.
[16]L Bebchuk (2004-5) 'The Case for Increasing Shareholder Power' *Harvard Law Review* at pg 833.
[17]Ibid; M McClenaghan (2012) "Delaware: the US tax haven of choice" The Beureau of Investigative Journalism; J Fish (2000) "The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters" *Faculty Scholarships* Paper 1312 at pg 1061.
[18]DE Wolf (*supra* note 13).

repurchase of the shares without recourse to the courts. It is submitted, however, that none of the laws referred to above differ so substantially from s164 so as to render their interpretation irrelevant to our courts.

1.5 The issues

This dissertation will consider how courts in England and the United States, with a specific focus on the state of Delaware, have dealt with the question of what fair value is. The second chapter (Chapter 2 – *English Law*) and third chapter (Chapter 3 – *The United States*) will give a brief introduction to valuations under the law of each jurisdiction in question. These Chapters will then discuss how courts in each jurisdiction have treated the meaning of 'fair', as well as the different and preferred methodologies of valuation. Chapter 2 and Chapter 3 will also consider how and why the courts of both the jurisdiction in question have refused to apply a 'Pro Rata' or 'Minority Discount' when valuating shares. In the final chapter (Chapter 4 – *Conclusion*), this dissertation will attempt to set out the approach best suited to the South African context when the question inevitably arises before the South African courts.

Chapter 2 – English Law

2.1 Introduction to valuations under English Law

As mentioned in Chapter 1 above, under English law share buy-outs are provided for in s996 (2)(e) of the English Act. The English legislature has not provided guidance on how shares are to be valued in terms of the section and the relevant principles must therefore be found in case law.[19] Richard Brockett[20] notes that despite extensive case law on oppression remedies in the United Kingdom, few clear principles have emerged in regard to valuation. Rather, Brockett[21] comments, the courts have worked "*within broad discretions and loosely expressed 'rules and principles' which do not give satisfactory clarity*". Indeed, he[22] remarks, the 'rules' espoused by the courts are subject to so many exceptions that in reality, the exceptions have become the 'rule'. Because it is so broad, Walker LJ warned in *Profinance Trust SA v Gladstone*[23], that this discretion must be exercised with great caution and lawyers must advise their clients as to the likely range of outcomes "*in order to encourage compromise in an area in which litigation can be cripplingly expensive*".

2.2 The meaning of 'fair'

Although neither the English Act of 2006, nor indeed any of the previous and now repealed English Companies Acts, have ever specifically referred to 'fair value', fairness is the key factor in determining the price to be paid for a minority shareholding.[24] In the English case of *Re Bird Precision Bellows Ltd*[25], Oliver LJ for the Court of Appeal held that the section dealing with unfair prejudice conferred on the court a very wide discretion to do what is considered fair and equitable in all the circumstances of the case, which discretion extended also to determining the manner

[19] P Hemmati & C Mitchell (2003) "Section 461 Share Buy-Outs: Principles of Valuation" *Kings College Law Journal Vol. 14* at pg 199.
[20] R Brockett (2013) "The Valuation of Minority Shareholdings in an Oppression Context – A Contemporary Review" *Bond Law Review 24(2)* at pg 105.
[21] Ibid.
[22] Ibid.
[23] [2002] 1 BCLC 141 at para 32.
[24] V Krishna (1987-1988) "Determining the 'Fair Value' of Corporate Shares" *Canadian Business Law Journal Vol 13* at pg 169.
[25] [1984] Ch 658.

in which the price is to be assessed. Brockett[26] notes that 'fair value' or 'fair price' does not equal 'market value' or 'fair market value' in a valuation sense.

2.3 Methodologies

The valuation of shares involve both subjective and objective elements, which, Brockett[27] notes, is further complicated where small, tightly held companies which do not have access to a highly competitive, negotiable market and which often lack sophisticated financial reporting capabilities are involved. It is also not always clear from judgments in oppression cases which approach has been adopted when the courts face the problem of ascribing value to shares. As Brockett[28] comments, the courts often leave the valuation to the experts nominated by the parties, and then consider the value each presented to the court, amending it according to the discretionary issues identified at trial. However, as was seen in the case of *Bilkus v King & Anor*[29], English courts are taking a more active role in determining the valuation method. There are different methodologies and each is likely to reach a different conclusion on the same facts.[30] Indeed, even use of the same methodology may result in different conclusions on the same facts. This is because the experts are likely to consider different factors (concerning the affairs and financial standing of the business) relevant in determining the value of the company and thereby the value of the shares. But not all methodologies are appropriate in all circumstances, as is discussed below.[31] Lord Millet in the case of *CVC/Opportunity Equity Partners Ltd v Demarco Almeida*[32] described the three possible methodologies as:

(i) a rateable proportion of the total value of the company as a going concern without any discount for the fact that the holding in question is a minority holding,

(ii) as before but with such a discount; and

[26] R Brockett (*supra* note 20) at pg 115.
[27] Ibid.
[28] Ibid at pg 119.
[29] [2003] EWHC 2516 (Ch).
[30] R Brockett (*supra* note 20) at pg 115.
[31] Ibid at pg 115.
[32] [2002] UKPC 16.

(iii) a rateable proportion of the net assets of the company at their break up or liquidation value.

2.3.1 Asset valuation

"Asset valuation" is the determination of value by assessing either the sale or replacement value of the physical and financial assets of the company.[33] Hemmati & Mitchell[34] are of the opinion that the English courts do not generally use an asset valuation method when making a share buy-out order, although they concede that there may be circumstances where a court might find it appropriate to do so. In the recent case of *Shah v Shah*[35] Roth J accepted that, in the specific circumstances, it was appropriate to value the company by reference to its net asset value, as the wholesaling garment business was loss-making and had no goodwill value.[36] In that case, it was accepted that since the net realisable value of its net assets exceeded the value that may be derived from the company's earnings, the asset valuation was appropriate.

2.3.1.1 The appropriateness of the asset valuation method

Hemmati & Mitchell[37] warn that asset valuation should really only be used where there is an intention to wind the company up. It should not, they[38] comment, be used to value a company as a going concern and is therefore not always appropriate when determining the fair value in a share buy-out. This is because, on paper and without proper context, the value of the company's assets will very rarely be an indicator of the company's future profitability. One would not be able to factor in assets such as reputation and customer loyalty. However, the asset valuation method is rational and the calculations fairly uncomplicated, giving the courts relative certainty and comfort.

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[33] P Hemmati & C Mitchell (*supra* note 19) at pg 202.
[34] Ibid.
[35] [2011] EWHC 1902.
[36] Ibid at para 45.
[37] P Hemmati & C Mitchell (*supra* note 19) at pg 202.
[38] Ibid.

2.3.2 Earnings valuation[39]

Hemmati & Mitchell describe 'earnings valuations' or the 'capitalization of earnings approach' as a measure of a company's value "*as a multiple of its maintainable future profits*"[40]. As they[41] describe, the maintainable future profit of a company is calculated by an expert valuer, after which a multiplier, referred to as an 'earnings multiple'[42] or as a 'price-earnings ratio' (hereon out the "**(P/E) ratio**"), is applied. The P/E ratio is the income a purchaser can expect to derive from his investment in a company.[43] Hemmati & Mitchell note that while the P/E ratio of listed companies can easily be gauged by dividing the company's listed share price by its annual earnings, determining the P/E ratio of an unlisted or private company is more complicated. In order to determine the P/E ratio of an unlisted or private company, an expert valuer will take the average P/E ratio of comparable listed companies (that is, companies that operate in the same sector and which have similar "*growth prospects, risk factors and financial structures*"[44]). Hemmati & Mitchell[45] comment that English courts invariably use the earnings valuation method when making a share buy-out order, using the evidence of expert valuers. It is interesting to note that other Commonwealth jurisdictions, such as Australia and Canada, have made move away from the abovementioned methodologies, instead opting for the Discounted Cash Flow method (discussed in more detail in Chapter 3),[46] although the courts in these jurisdictions have noted that there is no one-size-fits-all method, and the appropriate method will always depend on the relevant circumstances of the case.

2.3.2.1 The appropriateness of the Earnings Valuation method

Hemmati & Mitchell[47] note that the earnings valuation method is not without its weaknesses. First, little or no regard is given to inflation when this methodology is

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[39] This paragraph draws heavily on the work of P Hemmati & C Mitchell (*supra* note 19) at pg 202-204.
[40] Ibid at pg 202.
[41] Ibid at pg 203.
[42] R Brockett (*supra* note 20) at pg 110.
[43] P Hemmati & C Mitchell (*supra* note 19) at pg 203.
[44] Ibid.
[45] Ibid at pg 206.
[46] R Brockett (*supra* note 20) at pg 110.
[47] Ibid at pg 203.

used.[48] Second, the earnings value method does not take into account the fact that most firms expect to grow and have their profits increase over time, not merely remain stable. Moreover, there is no accounting method set in stone for the purposes of calculating a company's future earnings, and valuers can easily come to different conclusions as to what a company's future earnings would be.[49] Lastly, the method used to determine a P/E ratio for private companies are fairly arbitrary,[50] seeing as though a valuer is using one or more entirely different businesses to do so, all of which will have different risks, problems and opportunities. However, it is a more complete and realistic valuation method than the asset valuation method.

2.4 "Pro rata" or "minority discount"

It is common for a valuer valuing a company's shares (particularly in a private company) to apply a discount to reflect the fact that a holding is a minority one.[51] This is because, as Lord Millet noted in *CVC/Opportunity Equity Partners Ltd v Almeida*[52], a potential purchaser would usually be unwilling to pay a significant price for a minority holding in a private company. However, according to Hemmati & Mitchell[53], the judicial consensus emerging from English case law is that the shares of the minority shareholder requesting a buy-out should be valued "*on a pro rata, non-discounted basis where (as in most cases) the company is a quasi-partnership*". In *Re Bird Precision Bellows Ltd*, Oliver LJ rejected the contention that shares should be purchased at the market value of a minority holding. The judge, agreeing with Nourse J on appeal, considered that it would be unfair to force a minority shareholder to sell at a discount where it is the majority's behaviour that has effectively forced the shareholder to sell against his will. That is not to say a minority discount would never find application. Nourse J contemplated situations where such a discount would be appropriate, including where a minority shareholder "*acted so as to deserve his exclusion from the company*" or where a minority shareholder "*had bought into the company purely for investment purposes, with no expectation of active*

[48] Ibid
[49] Ibid
[50] Ibid
[51] Ibid at 204.
[52] [2002] UKPC 16.
[53] P Hemmati & C Mitchell (*supra* note 19) at 207.

participation".[54] In *Re DR Chemicals Ltd*[55], a quasi-partner who was unfairly excluded from management, but who then left his money in the company for a long period, was treated by the court as though he had originally bought the shares for investment purposes.

2.5 Date of valuation

Whilst Hemmati & Mitchell[56] comment that the appropriate date on which the valuation is to take place will depend on what would be fair in the circumstances, Brockett[57] notes that the shares should, in principle, be valued as on the date on which the purchase order is given by the court. Depending on the particular facts of the case it may be appropriate for a court to depart from this position. This is the position taken in *Re London School of Electronics Ltd*[58], wherein Nourse J concluded that, because of the petitioner's own conduct, the date of the proceedings would be more appropriate,[59] as this would "*have given the petitioner the benefit of improvements in the company's affairs which were "entirely due" to the efforts of the other shareholders*".[60] In *Re A Company 002612 of 1984*[61] Vinelott J said that a departure from the date of petition as the date of valuation must be justified on the ground of some special circumstance. In *Profinance Trust SA v Gladstone,* Walker LJ, referring to the decision in *Re OC (Transport) Services*[62] noted that the clearest reason for selecting an early valuation date is that there has been a major change (whether for the better or for the worse) in a company's capital structure and business. In *Re OC (Transport) Services*, a Canadian case, the majority shareholder had used his control to increase the company's issued capital by 750 per cent and to make it a partly-owned subsidiary of another company of his.

[54] Ibid at 208.
[55] [1989] BCLC 383.
[56] P Hemmati & C Mitchell (*supra* note 19) at 209.
[57] R Brockett (*supra* note 20) at pg 129.
[58] [1985] 3 WLR 474.
[59] A Hicks (2008) *Cases and Materials on Company Law* OUP Oxford at pg 474.
[60] P Hemmati & C Mitchell (*supra* note 19) at pg 212.
[61] [1985] BCLC 80.
[62] [1984] BCLC 251

Hicks[63] comments that valuations may be either at a time prior to the unfairly prejudicial conduct that occasioned the petition by the minority shareholder, the time of exclusion of that minority shareholder from the company, the date of the petition itself or the judgement or, in fact, the date of the actual valuation. He comments further that specific assumptions may be made in the process of valuation, including the assumption that the unfairly prejudicial conduct depreciating the value of the shares did not occur.[64] Hicks[65] concludes that each case has to be taken on its facts and an attempt to generalise as to the basis for valuation date is not useful.

2.6 Conclusion

The English courts have a broad discretion to determine, according to what would be fair to both parties in the circumstances, what 'fair value' of the shares would be. This, it is submitted, is as it should be. Expert valuers will invariably come to different conclusions as to the value of the company and as to the shares of that company, no matter what method of valuation is used or even if the same method is used, and the court should have a wide discretion as to which method of valuation is more accurate and most fair in the circumstances. However, English courts have favoured the earnings valuation method above the asset valuation method, though choosing to apply the latter may be more appropriate only in certain instances where it would be fair to do so. Again, it is submitted that this is logical, seeing as the asset valuation method is likely to be neither fair to petitioners, nor an accurate reflection of a company's fair value. However, the earnings valuation method is not without its limits, and perhaps a better method (as will be discussed in Chapter 3 below) is the one that has found favour in the United States (as well as some Commonwealth countries), that being the Discounted Cash Flow method. The courts have further held that no discount should be given because the shareholding is a minority one, unless it would be fair in the circumstances to do so – for example, where the conduct of the minority shareholder warrants it. This is as it should be, as it will encourage the majority to attempt a compromise. Finally, the English courts have held that the date on which the valuation of the shares should be based should, in the absence of special circumstances, be the

[63] A Hicks (*supra* 59) at pg 474.
[64] Ibid.
[65] Ibid.

date on which the purchase order is granted, but that this date falls within the discretion of the courts and will depend on the circumstances. S164 of the South African Companies Act specifically sets out that the fair value in respect of any shares must be determined as at the date on which, and time immediately before, the company adopted the resolution giving rise to the appraisal remedy. This may cause unfairness in certain circumstances, but it is submitted that the certainty in such an uncertain area of law will be welcome. However, it can be argued that this should have been left to the discretion of the South African courts as well.

Chapter 3 – The United States

3.1 Introduction to valuations under the law in the United States

RJ Campbell[66] remarks that in the US, all corporate statutes provide some form of appraisal rights for stockholders (or shareholders) who hold shares in companies that are acquired in statutory acquisitions. These appraisal rights, he[67] notes, require no wrongdoing or conflict of interest on the part of persons or entities involved in the transaction. Shareholders who exercise their appraisal rights are entitled to receive cash equal to the 'fair value' of their shares.[68]

Campbell[69] argues that the drafters of the Model Act left the appraisal statute ambiguous, the intent being to delegate to courts the task of determining the essential components of, and methodologies for, calculating fair value and to reaffirm, or at least leave unchanged, the existing jurisprudence on these matters. The same could be said of the DGCL, which provides little direction as to how fair value is to be determined.

3.2 General Rules from the different states

It should be noted that very few appraisal claims have been litigated outside the state of Delaware (discussed below) and that the courts in other states often have little experience with these claims. Nevertheless, DE Wolf[70] warns that it should not be assumed that the courts in states outside of Delaware will come to the same conclusions as the Delaware Court of Chancery and Delaware Supreme Court in appraisal matters.

One rule that does seem well settled in the case law of the different states is that fair value is based on the going concern value of the company and not on the liquidation

[66] RB Campbell (2000) "Fair Value and Fair Price in Corporate Acquisitions" *North Carolina Law Review Vol 78* at pg 108.
[67] Ibid.
[68] Ibid at pg 102.
[69] Ibid at pg 117.
[70] Wolf (*supra* note 13).

value of the company.[71] However, Campbell[72] notes that some courts will allow liquidation value to "seep" into going concern value calculations by considering liquidation value as a component of going concern value. Campbell[73] gives the example of the Delaware Block Method (which is a method used outside of Delaware as well)[74], under which liquidation value or, as it is called, "asset value," is typically accorded significant weight in the present value calculation.[75]

However, the courts of the different states diverge in opinion as to whether fair value should be reduced to reflect a minority discount (as discussed under Chapter 2 and as discussed further below), although it would appear that most conclude that such discounts should not be considered in fair value calculations.[76] In contrast, the courts in states such as Kentucky have applied the minority discount when determining the fair price of shares.[77]

3.3 Introduction to valuations under the law in Delaware

As mentioned in the Chapter 1 above, s262 of the DGCL makes provision for a shareholder who unsuccessfully opposes a merger on the basis of insufficient price to petition the Delaware Court of Chancery to determine the stock's (or share's) 'fair value'.[78] No guidance is given by the section as to how fair value is to be determined, but the section does provide that "*all relevant factors*" must be considered, though these considerations had to be "*exclusive of any element of value arising from the accomplishment or expectation of the merger*".[79] What constitutes fair value, therefore, has had to be developed through the courts.[80]

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[71] Ibid at pg 118.
[72] Ibid at pg 119.
[73] Ibid at pg 119.
[74] Ibid at footnote 55.
[75] Ibid at pg 119.
[76] Ibid at pg 121. The following are examples of cases that measure fair value by the dissenter's proportionate share of the entity as a whole: *Shell Oil*, 607 A.2d at 1218; *Rapid-American*, 603 A.2d at 802; *Cavalier Oil*, 564 A.2d at 1144; *McLoon Oil*, 565 A.2d at 1004.
[77] 122 at footnote 67.
[78] BA Margolin & SJ Kursh (2005) "The Economics of Delaware Fair Value" *Delaware Journal of Corporate Law Vol 30* at pg 413.
[79] Ibid at pg 414.
[80] Ibid at pg 415.

3.4 What is fair?

As is the English position, the courts in Delaware have distinguished fair value in s262 from commonly accepted valuation standards such as fair market value.[81] BA Margolin & SJ Kursh[82] observe that the courts in Delaware have generally accepted "*the pro rata value of the entire firm as a going enterprise*" to be the fair value, as opposed to the company's value in the context of an acquisition, liquidation or other transaction.

In *Weinberger v. UOP, Inc.*[83] Justice Moore for the Supreme Court of Delaware held that determining fair price requires consideration of all relevant factors. Referring to the Supreme Court of Delaware judgement in *Tri-Continental Corporation v Battye et al*[84], Justice Moore agreed that only the speculative elements of value are excluded from consideration. Any elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger may be considered.[85] Fair value, the judge said, also includes any damages which the shareholders sustain as a class.[86]

The Delaware Supreme Court in *Cavalier Oil Corp. v. Harnett*[87] reasoned that fair value should "*assume that the shareholder was willing to maintain his investment position, however slight, had the merger not occurred*". Thus, as Margolin & Kursh[88] note, the task is to value what has been "*taken*" from the shareholder – which is ultimately his proportionate interest in the going concern. These writers comment that the purpose of appraisal rights are to prevent management from forcing the minority to tender its shares at a price less than that which would be fair value. Fair value, they continue, has been viewed by the courts as "*the value of a firm if management held all*

[81] Ibid at pg 416.
[82] Ibid at pg 414.
[83] 457 A.2d 701 (1983).
[84] 74 A. 2d 71 - Del: Supreme Court 1950.
[85] *Weinberger v. UOP, Inc.*457 A.2d 701 (1983) at para 714.
[86] Ibid at para 713.
[87] 564 A. 2d 1137 - Del: Supreme Court 1989 at para 1145.
[88] Margolin & Kursh (*supra* note 78) at pg 415.

its equity; in other words, if opportunities for managerial malfeasance did not exist"[89]. As discussed in Chapter 1, this is broadly in line with the English position.

3.5 Methodologies

In the past and up until 1983, the Delaware courts almost exclusively used the Delaware Block Method to determine share value.[90] However, as Margolin & Kursh[91] note, in the case of *Weinberger v. UOP, Inc.* the Supreme Court of Delaware broadened the acceptable methodologies to any methodology commonly used in business valuation, including the use of the different elements of the Delaware Block Method individually (as discussed below). The court specifically held that determination of fair value "*must include proof of value by any techniques or methods which are generally considered acceptable in the financial community*" and that the Delaware Block Method was not necessarily sufficient in this determination.[92] As is the case under English Law, the valuation technique that the court will use is highly dependent on the evidence presented by the parties, and the valuation methods chosen by their respective expert valuers.[93]

3.5.1 Delaware Block Method

Under this approach, three elements of value are examined – the earnings (also known as investment) value, market value and asset value. Mathematical weightings are assigned to each (although, as explained by S Pratt[94], one or even two of the three elements could be given a zero weighting). The type of business, the objectives of the company and other relevant factors are taken into consideration when determining the weight given to each element. The three elements of value are examined below.

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[89] Ibid.
[90] Krishna (*supra* note 24) at pg 157.
[91] Margolin & Kursh (*supra* note 78) at pg 415.
[92] S Pratt (2002) "The Lawyer's Business Valuation Handbook: Understanding Financial Statements, Appraisal Reports, and Expert Testimony" *American Bar Association* at pg 355 and *Weinberger v. UOP, Inc*. (*supra* note 19) at para 713.
[93] Barry M. Wertheimer (1998) "The Shareholders' Appraisal Remedy and How Courts Determine Fair Value" *Duke Law Journal Volume 47 Number 4* at pg 629.
[94] Pratt (*supra* note 92) at pg 35.

3.5.1.1 Earnings or investment value (hereon out referred to as investment value)

Investment value is value based on expected earnings or dividends.[95] Briefly, investment value is, as Krishna[96] explains, "*premised on the principle that an asset or property is worth what it can earn in the future*". The traditional approach to estimating an company's future earnings is to infer from an average of its past earnings, after making adjustments for any known changed circumstances. Once this is done a capitalisation rate is used to determine the expected rate of return of the shares if earnings perform as estimated. Investment value is not to be confused with earnings valuation under Chapter 2 of this dissertation.

3.5.1.2 Market value

The market value is calculated the same way earnings valuation, dealt with under Chapter 2, is calculated. The market value for the shares of a publically listed company is usually easily ascertainable, as a court can simply look to the listing price of the company's shares. But Krishna[97] warns that there are severe shortcomings to this, as the stock market can easily be influenced by irrational pressures and panic – and it generally anticipates and reflects the financial impact of whatever corporate action is going to give rise to the appraisal right. Rolnick, Hecht & Hampson[98] note that a comparable companies analysis can be used to calculate a value for a company based on the share price of a similar, publicly traded company or companies. However, these writers admit that no two companies are truly identical, and the expert valuer must use his or her judgment to determine whether there are sufficiently similar characteristics between the two. Understandably, the more similar the companies are, the more weight the court is likely to place on a comparable companies valuation. In the case of *Merion Capital, LP v. 3M Cogent, Inc*[99], Vice Chancellor Parsons for the Delaware Court of Chancery explained the method as follows:

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[95] Krishna (*supra* note 24) at pg 157.
[96] Krishna (*supra* note 24) at pg 148.
[97] Krishna (*supra* note 24) at pg 156.
[98] LM Rolnick, SM Hecht & M Hampson (2013) "Valuation Basics: Comparable Companies Analysis" *Appraisal Rights Litigation Blog*. Available online at http://www.appraisalrightslitigation.com/2015/06/10/valuation-basics-comparable-companies-analysis/ [Last Accessed 2 August 2015].
[99] No. 6247-VCP.

> *"The comparable companies method of valuing a company's equity involves several steps including: (1) finding comparable, publicly traded companies that have reviewable financial information; (2) calculating the ratio between the trading price of the stocks of each of those companies and some recognized measure reflecting their income ...; (3) correcting these derived ratios to account for differences, such as in capital structure, between the public companies and the target company being valued; and, finally, (4) applying the average multiple of the comparable companies to the relevant income measurement of the target company..."*

3.5.1.3 Asset valuation

As discussed in Chapter 2, asset valuation is premised on the idea that the shares of a company represent a claim to a proportionate share of corporate assets upon liquidation.[100] The value of the company amounts to the value of the assets of the company less the company's liabilities and any preference equity (that is, claims from preference shareholders).[101]

3.5.1.4 The appropriateness of using the Delaware Block Method

Krishna[102] notes that whilst the Delaware Block Method will usually assist a dissenting shareholder where the company offers him the market price of his shares at a time when the market value is less than asset value, this method may work to the majority's advantage instead, as it is all a matter of averaging. Wertheimer[103] explains that this approach is simply too mechanical. He[104] notes that it does not accord with new and developing financial methods of valuation, and so has recently fallen out of favour.

[100] Krishna at 154.
[101] Krishna at 154.
[102] Krishna (*supra* note 24) at pg 159.
[103]Wertheimer (*supra* note 93) at pg 629.
[104] Ibid.

3.5.2 Discounted Cash Flow Method

Hecht and Hampson[105] comment that the Discounted Cash Flow ("**DCF**") method has in recent times become the generally accepted method of valuation in Delaware. They[106] describe the DCF method as the discounting of a company's projected future cash flows to a present value based on the perceived risk of investing capital in that company.

Future cash flows are calculated by determining the operating cash flow or income of the company, less the company's capital expenditure. This future cash flow is then adjusted to take into account the time value of money - thus, the discounted value represents the equivalent current value of the company's future stream of cash earnings.[107] Krishna[108] comments that the process of discounting is simply the converse of compounding. He gives the following example:

> *"…if a dollar invested at 10% today will be worth \$1.10 a year from now and, if compounded, \$1.21 two years from now, then \$1.21 due two years hence must be worth a dollar today if the prevailing rate of interest is 10%."*

3.5.2.1 The appropriateness of using the DCF method

Krishna[109] cautions that there are theoretical disadvantages to the DCF method. The idea that the selected stream of earnings or discount rate will remain constant is flawed. This is because interest rates fluctuate and are not entirely predictable, as well as because it is almost impossible to predict the free cash flow of a company into perpetuity. Prediction of free cash flow and then selection of the appropriate discount rate can be a messy process – and one that will be different from expert valuer to expert valuer. However, it is the method that most accurately takes into account the realities of economics. Projections of future earnings can be skewed if the companies in a specific industry or sector are over- or undervalued. Furthermore, free cash flow is a

[105] Hecht & Hampson (2013) "Valuation Basics: Determining a Discount Rate, or WACC" *Appraisal Rights Litigation Blog*. Available online at http://www.appraisalrightslitigation.com/2013/09/13/valuation-basics-determining-a-discount-rate-or-wacc-3/ [Last Accessed 2 August 2015].
[106] Ibid.
[107] Ibid.
[108] Krishna (*supra* note 24) at pg 160.
[109] Ibid.

far more reliable indication of a company's value than reported earnings, because free cash flow is not just profit – it is what is left over and available entirely for investment or distribution, and is not trapped in assets that need to be realised.

3.5.3 Merger Price

In the recent matter of *Huff Fund Investment Partnership v. CKx, Inc.*[110] the Delaware Court of Chancery held that the merger price produced by a "*thorough, effective" sales process, free from any spectre of self-interest or disloyalty*," could be the most reliable indicator of the value of shares.[111] The Chancery held that while a court may not presume the merger price to be the best indicator of fair value, it may well find the merger price to be the most reliable indication of value. This was confirmed by the Delaware Supreme Court[112], and the same conclusion was reached in the later matter of *In Re Appraisal Of Ancestry.Com, Inc.*[113]. In the *Ancestry.com* case, Vice Chancellor Glasscock, having been entirely persuaded by neither of the evaluations provided by the expert valuers of the parties, held that fair value in the circumstances was best represented by the market price. The Vice Chancellor noted that he had "*comfort that no undetected factor skewed the sales process*" and also took comfort that the merger price was close to the DCF valuation of the most reliable expert valuer. It should be noted that in both of the above cases, the mergers had taken place by means of auction, seemingly at arm's length.[114]

3.5.3.1 The appropriateness of using the Merger Price

The merger price will not be the appropriate measure of value in the valuation of shares for all appraisal matters. In the two cases mentioned above, *Huff Fund Investment Partnership v. CKx, Inc.* and the *In Re Ancestry.Com, Inc.* case, the specific circumstances were instrumental in the Delaware Court of Chancery and the Delaware

[110] Civil Action No. 6844-VCG.
[111] W Savitt (2013) "Court Holds Merger Price Is Reliable Indicator of Fair Value" *Harvard Law School Forum on Corporate Governance and Financial Regulation*. Available online at http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.22921.13.pdf [Last Accessed: 15 August 2016].
[112] Del: Supreme Court No. 348, 2014.
[113] Civil Action No. 8173-VCG.
[114] Savitt (*supra* note 111).

Supreme Court reaching their decisions. In both of these cases, there had been an arm's length auction of the shares, and there was little chance of the majority using its relative influence over the minority shareholders to exact an unfair price for the minority's shares. The court must use its discretion in such cases, and must be certain that the price reached is fair for both parties. However, it is, as W Savitt[115] notes, a reminder to shareholders that appraisal proceedings (which are often exceedingly costly) carry significant risk and a shareholder may after all receive only the deal consideration.

3.6 "Pro Rata" or "Minority Discount"

The courts of Delaware have expressly excluded the application of a minority or 'lack of control' discounts, and this exclusion extends to other interest level discounts, including those for lack of marketability.[116] In 1989, the Supreme Court of Delaware in the case of *Cavalier Oil Corp. v. Harnett*[117] held that:

> *"…the appraisal process is <u>not intended to reconstruct a pro forma sale</u> but to assume that the shareholder was willing to maintain his investment position, however slight, had the merger not occurred. <u>Discounting individual share holdings injects into the appraisal process speculation on the various factors which may dictate the marketability of minority shareholdings.</u> More important, to fail to accord to a minority shareholder the full proportionate value of his shares <u>imposes a penalty for lack of control</u>, and <u>unfairly enriches the majority shareholders</u> who may reap a windfall from the appraisal process by cashing out a dissenting shareholder, a clearly undesirable result".* (Underlining for my emphasis)

Indeed, the Delaware Court of Chancery has held that stock market data may include an "implicit minority discount," and accordingly, has permitted the application of "control premiums" in comparable public company analyses, which up the value of shares to compensate for this minority discount. The concept of control premiums has been criticised by some legal commentators, particularly when dealing with listed companies, as it is argued that the control premium may already be reflected in the

[115] Ibid.
[116] Margolin & Kursh (*supra* note 78) at pg 416.
[117] 564 A.2d 1137, 1145 (Del. 1989).

market or listed price.[118] These commentators argue that, save for a complete change of control, control premiums should not be applied.[119]

3.7 Date of Valuation

S262 of the DCGL provides that in appraisal proceedings, a court must consider all relevant factors "*exclusive of any element of value arising from the accomplishment or expectation of the merger*". Courts in Delaware will, therefore, not take into consideration any transactions or events that occur after the event of a merger.[120] Fair value is to be determined at the effective date of the merger.[121] For that reason, a shareholder will be unable to participate in any unforeseen rise in value, but will also be protected from any sudden loss in value, of the shares. This is different to the English position, in that the English courts have discretion to choose the valuation date, though the date of petition is usually taken as the date on which the court will base its valuation.

3.8 Conclusion

The different states in the United States have different corporation legislation, and as a result the courts of each may come to different interpretations when it comes to fair value of shares in the exercising of appraisal remedies. As most companies are incorporated in the State of Delaware, the body of jurisprudence in that state, while having established some fairly hard rules, continues to develop most rapidly. In that state, determining fair price requires consideration of all relevant factors involving the value of a company, and it has been held that only speculative elements should be disregarded. The Delaware Block Method, once the most commonly used method of determining that value of shares, has now fallen out of favour and has been replaced by the DCF method. The DCF method has, as was mentioned in Chapter 2, also found

[118] GE Matthews and M Patterson in JR Hitchner (2011) *Financial Valuation: Applications and Models* New Jersey: John Wiley & Sons at Chapter 16, Addendum 1, pg 2.
[119] Ibid.
[120] SM Hecht (2013) "Post-Merger Evidence Is Generally Not Admissible to Prove the Company's Fair Value: Actual Results May Vary" *Appraisal Rights Litigation Blog*. Available online at: http://www.appraisalrightslitigation.com/2013/08/29/post-merger-evidence-is-generally-not-admissible-to-prove-the-companys-fair-value-actual-results-may-vary/ [Last Accessed: 16 August 2015].
[121] Ibid.

favour in some Commonwealth of Nations jurisdictions, including Canada and Australia (both of which, like South Africa, have corporations legislation and jurisprudence that are deeply rooted in English law). As is the English law position, the courts in Delaware do not apply a minority discount and indeed in this state the Court of Chancery often applies control premiums in order to address the implicit minority discount to be found in share prices. Not all states in the United States follow this position, as has been seen in the State of Kentucky, where minority discounts are factored into valuation. Furthermore, in contrast to the English position, s262 of the DCGL provides that the valuation date is the date of the merger. This is also the South African position as well, and though it provides some measure of certainty, it can be criticised in that it can result in an unfair outcome in certain circumstances, particularly when the shareholder conducts him- or herself in such a manner as to warrant the inclusion of events after the merger in the valuation analysis. It is submitted that the English position, that is, that the date of valuation falls within the courts discretion, is the correct position, though the certainty in this area will surely be welcomed.

Chapter 4 - Lessons for the South African context

4.1 The warnings

The area of appraisal remedies is an uncertain one. In distilling the principles from the foreign jurisdictions discussed above, only one principle is absolutely certain: there is no one-size-fits-all answer to the problem, and ultimately, a South African court will be left with a wide discretion to determine what would be fair to both parties in the specific circumstances of the case before it. It must be noted that s164 of the South African Act is not punitive – after all, it requires no wrongdoing on the part of any persons involved in the event giving rise to the appraisal remedy. It is therefore important that legal advisors always ensure that shareholders wishing to use the remedy are aware that the process will undoubtedly be a lengthy and expensive one, and that the shareholder is not guaranteed a higher price than that which has been offered by the company. In addition, the shareholder (and indeed the company itself) will have to present to the court a valuation by an expert valuer, a process which in itself may be too costly for an individual shareholder, depending on the size and nature of the company. A shareholder must weigh up the risks before attempting to use the appraisal remedy. It is also important to note that the appraisal remedies in each of the abovementioned jurisdiction have changed significantly over time. The area of appraisal rights are fluid and changing, and courts must keep up with modern accounting and valuation trends.

4.2 Discretion of the courts

As the legislature has provided little guidance as to how the fair value of shares is to be determined, it seems likely that the courts will ultimately be forced to use their discretion. A court will be required to analyse the expert valuations by the parties, each of which, depending on the methodology and accounting procedures used, may legitimately come to very different conclusions. However, it is submitted that the court must also use its own initiative if not convinced by the valuations of either party, or where it would be most fair to do so, as was the case in the Delaware matters of *Huff Fund Investment Partnership v. CKx, Inc.* and *In Re the Appraisal of Ancestry.com*. As is seen in the jurisdictions discussed above, a court must take into account all the relevant factors in *casu* when determining fair value. It is submitted, however, that the South African courts must apply the same caveat as that applied in Delaware, being that no speculative or unforeseen factors can be taken into account.

4.3 Value of the company as a going concern

It is submitted that the South African courts would be wise to treat the company that is the subject of the appraisal right as if it were a going concern, and not as though it were being wound up or liquidated, unless it would be most fair in the circumstances to do so (for example, where the company is factually insolvent or not making a profit). This is a principle followed both in English law and in the US. It is for that reason that it is also submitted that relying only on an asset valuation will not be appropriate in most cases. As was discussed above, asset valuations do not give a complete picture of the value of a company, and many assets of a company (such as reputation and customer loyalty) cannot readily or accurately have a value ascribed to them.

4.4 Fair Value is not (necessarily) market value

It is trite both in English law and in that of the State of Delaware that fair value is not, under normal appraisal circumstances, the same as market value. It is submitted that the South African courts should follow the same principle. This is especially the case when dealing with a private company, as the potential market for privately-held shares is much smaller and the price for which the shares could be sold will seldom provide a fair price. That is not to say that the market price will never be appropriate. It is submitted that South African courts should note the course taken in *Huff Fund Investment Partnership v. CKx, Inc.* and *In Re the Appraisal of Ancestry.com*, wherein the courts of Delaware held that a sale at arm's length of a publically listed company was the best indicator of value. The *ratio decidendi* of that case is apt – that a court should not assume that the market value of the shares is the fair value, but that it may well be.

4.5 Minority discounts are not appropriate

Both the English and the Delaware position is that minority discounts are not to be applied when determining the fair value of shares, as it would be unduly prejudicial to the minority shareholder who would, had the event giving rise to the appraisal remedy not occurred, have wished to remain an investor in the company. It is submitted that this should be appropriated into South African law. However, it is also submitted that the Delaware practice of applying control premiums in order to erase the implicit minority discount found in stock market prices will not, in most circumstances, be appropriate. This is because the implicit minority discount is nearly impossible to prove and creates unnecessary uncertainty in an already indeterminate area of the law.

4.6 The DCF method is the most appropriate method of valuation (for now)

It is submitted that the DCF method would, in most circumstances, be the most appropriate method of valuation. The international trend, not only in judgements but in the business world as well, is to rely increasingly on this method, and its application can be found in US, Canadian and Australian jurisprudence. It has even found mention in the English case law, though it is not yet the preferred method in that jurisdiction. That being said, it must be remembered that accounting and valuation methods are continually changing, however slowly, and the South African courts must be able to adapt to changing international standards. As was discussed in Chapter 3 above, the Delaware Block Method was almost exclusively the method of valuation for almost all states in the United States for decades, before the courts in those jurisdictions were forced to concede that the method had become too rigid and outdated. Therefore, it is submitted that setting hard and fast rules in this regard will be to the detriment of shareholders wishing to exercise their appraisal rights in the future.

4.7 Conclusion

The jurisprudence of appraisal rights in the different jurisdictions is exciting and ever-changing, but it is not a right to be exercised without careful and considered weighing of the risks involved, particularly when it comes to determining the fair value of shares. It is submitted that there is no reason for the proverbial 'reinvention of the wheel' when it comes to determining fair value. South African courts would do well to appropriate the lessons learnt both in the English and the United States experience, as has been done in other jurisdictions. Whether this will be the case remains to be seen.

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