Worth How Much and To Whom?

Valuing Minority Stock After *Ritchie v. Rupe*

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In the Spring of 2011, the Dallas Court of Appeals became the eleventh of the fourteen Texas appellate courts to recognize the tort of minority shareholder oppression. *Ritchie v. Rupe*, 339 S.W.3d 275 (Tex. App.–Dallas 2011, pet. filed) (11-0447) (hereinafter "*Rupe*"). *Rupe* is a unique and groundbreaking shareholder oppression case because it is the first Texas case that addresses how trial courts should value a minority investor's stock. The court's valuation holding in *Rupe* presents numerous issues of law, business valuation, and strategy for lawyers representing clients in shareholder oppression cases.

After explaining *Rupe*'s factual and procedural background, this article boils down these new issues to four essential questions: (1) was Rupe simply a case of charge error?; (2) after *Rupe*, how do lawyers determine whether fair market value or fair value applies to a shareholder oppression claim?; (3) if *Rupe's* pricing discounts do apply, what is the proper way to calculate the fair market value of a minority stock in a closely-held corporation?; and (4) in order to avoid *Rupe's* pricing discounts, can a plaintiff seek a remedy for shareholder oppression other than a buy-out?

Rupe's Factual and Procedural Background

The *Rupe* case was filed in 2006 and tried in 2009. *Rupe*'s origins began with Rupe Investment Corporation ("RIC"), a company founded by the plaintiff's father-in-law and his business partner. 339 S.W.3d at 281. By the time of the lawsuit, all but 1.7% of RIC's stock was held in trusts for the benefit of the founder's descendants. *Id*. One of those trusts was known as Buddy's Trust, which owned 18% of RIC (the "Stock"). *Id*. at 282. Buddy, the son of RIC's co-founder Dallas Gordon Rupe, Jr., was trustee of Buddy's Trust until his death in September 2002. *Id*. at 281-82. After Buddy died, his wife, Ann Caldwell Rupe ("Ann") succeeded him as trustee of Buddy's Trust. *Id*. at 282.

"For purposes of [the Dallas Court of Appeals], the overriding dispute here concerns Ann's efforts to sell the Stock to third parties." *Id*. After Buddy's death, Ann contacted RIC's president, Lee Ritchie ("Ritchie") about RIC buying the Stock. *Id*. RIC was under no obligation to redeem the Stock – there was no shareholder agreement containing a standard buy-sell provision. *Id*. When Ann and RIC's president could not reach agreement about RIC's redemption of the Stock, Ann marketed the Stock to third parties. *Id*.

In 2004, Ann hired a retired capital fund manager, George Stasen ("Stasen"), to help her market and sell the Stock to a third party. *Id*. In 2006, Ritchie faxed a letter to Ann that stated: "it would be inappropriate for me or any other officer or director of [RIC] to meet with your prospects or otherwise participate in any activities relating to your proposed sale of stock." *Id*. In addition to the letter, Stasen also testified that Ritchie "told him that neither Ritchie nor any member of RIC's management would meet with any prospective purchasers of the Stock." *Id*.

Not surprisingly, the third parties to whom Ann and Stasen were trying to sell the Stock wanted to meet with RIC's management, and the refusal to meet prevented the sale. Stasen testified at trial that he "got laughed at" by prospective investors when he told them they could not meet with RIC's management. *Id*. "Stasen testified the chance of selling stock in a closely held corporation without affording the prospective purchaser an opportunity to meet with management was 'zero.'" *Id*.

In the summer of 2006, Ann filed suit against numerous defendants in their individual capacities, and later added RIC as a defendant. *Id*. at 283. Ann's lawsuit alleged a claim for shareholder oppression that was based, in part, on the refusal of RIC's management to meet with Ann's prospective buyers. The case proceeded to a multi-week jury trial in Dallas County's 44th Judicial District. One of the questions in the jury charge asked the jury to find the Stock's "fair value." The charge instructed that "fair value" of the Stock: "meant the value of the Stock, determined: (a) As of June 30, 2006; (b) Using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and (c) Without discounting for lack of marketability or minority status." *Id*. at 299. Under this charge, the jury found that the fair value of the Stock was $7.3 million. *Id*. at 283.

Relying on the jury's finding, the trial court ordered RIC to pay Buddy's Trust $7.3 million to redeem (or "buy-out") the Stock. *Id*. RIC appealed, focusing on whether the trial court abused its discretion in ordering the buy-out as an equitable remedy. But RIC did argue that even if the court-ordered buy-out withstood appellate scrutiny, the trial court erred because it "wrongly valued" the Stock by relying upon the jury's determination of $7.3 million as the Stock's fair value. *Id*. at 299. By instructing the jury to not "discount[] for lack of marketability or minority status," the trial court told the jury to calculate the Stock's enterprise value. *Id*. at 300. Enterprise value is calculated by valuing "the company as a whole and ascribing to each share its pro rata portion of that overall enterprise value." *Id*. Practically, if a plaintiff is a 10% shareholder in a $10 million company, the enterprise value of her stock is $1 million.

By contrast, calculating the fair market value of a closely-held stock requires the application of two key valuation discounts – one for the shareholder's lack of control of the business (the "minority discount") and the other for lack of marketability (the "marketability discount"). The minority discount reflects that shareholders are willing to pay more for a controlling stake in a company. *See* Douglas K. Moll, *Shareholder Oppression and "Fair Value,"* 54 Duke L.J. 293, 315-16 (2004). Because a minority shareholder cannot normally provide the buyer with control of the entity, prospective buyers will discount the value of closely-held stock by approximately 30% to reflect this lack of control. *Id*. at 316 & n.90.[1] Applying just the minority discount to our

[1] The approximate estimates for these discounts are taken from Professor Moll's article and are for illustrative purposes onl . They are not intended to, and do not, act as a benchmark for any particular valuation, which should be the subject of expert testimony specific to the pending case.

hypothetical 10% shareholder, the value of her stock dips from $1 million to $700,000.

But the marketability discount may be included as well. Because there is no ready public market for closely-held stock, "it is considerably more difficult to sell close corporation stock than public corporation stock." *Id*. at 316. The marketability discount reduces the fair market value of closely-held stock by approximately another 35% to account for this difficulty. *Id*. at 317-18 & n.96. If both discounts apply to our hypothetical 10% shareholder, the fair market value of her stock would be $455,000 – less than half of her $1 million enterprise value.

In *Rupe*, the Dallas Court of Appeals found that the trial court abused its discretion by ordering RIC to buy-out Buddy Trust's Stock for its enterprise value – $7.3 million – because enterprise value was more relief than Buddy's Trust was entitled to. The Dallas Court of Appeals identified the harmful conduct alleged by Rupe – that RIC would not cooperate with the sale of the Stock to a third-party – and analyzed that if the Stock had been sold to a third-party, it likely would have been subject to the minority and marketability discounts. Assuming the average minority and marketability discounts discussed above applied to Rupe's claims, the fair market value of the Stock would be approximately $3.3 million – or $4 million less than the jury and trial court awarded.

Minority and marketability discounts have the drastic effect of greatly reducing the value of closely-held stock.[2] Accordingly, *Rupe* raises four significant questions for lawyers representing shareholder oppression plaintiffs and defendants alike. Each is addressed below.

Was *Rupe* Simply a Case of Charge Error?

At first blush, *Rupe* may appear to simply be a case of charge error. The trial court instructed the jury to not apply the minority and marketability discounts; the jury followed the court's instruction, and the trial court relied on the jury's findings in crafting equitable relief to order RIC to buy-out Buddy's Trust for $7.3 million. *Rupe*, 339 S.W.3d at 299. It stands to reason that, if the trial court had permitted the jury to consider the discounts and they had chosen not to apply them, the fair value judgment may have been upheld.

This argument is compelling in its simplicity, but reducing *Rupe* to charge error ignores that it is the trial court – not the jury – that must find shareholder oppression and determine the proper equitable relief. *Id*. at 289. While the jury's answer to the valuation question in the charge is helpful, it is neither controlling nor binding on the trial court. The trial court is bound by equity to ensure that the relief granted by the jury does not exceed the harm suffered by the plaintiff. The trial court in *Rupe* undoubtedly exercised its discretion – the record reflects a hearing, held after the jury verdict, to determine the proper scope of relief – but the Dallas Court of Appeals found the judgment awarded Rupe more than she would have received if RIC had not committed shareholder oppression by restricting her ability to sell the Stock to third-parties. *Compare id*. at 283 (describing the post-verdict hearing) *with id*. at 301 ("In crafting an equitable remedy for appellants' oppressive conduct in connection with [Rupe's] efforts to sell the Stock, the trial court should have provided the relief prevented by [defendants'] conduct, *i.e.*, a sale at fair market value.").

The issue in *Rupe* was not whether the jury charge was flawed – even if the charge instructed that minority and marketability discounts should apply, the trial court decides what equitable relief to award, and if it awards enterprise value where fair market value is appropriate, it may be awarding too much relief. Thus, the primary question *Rupe* raises is this – how do lawyers determine whether fair market value or enterprise value applies to a shareholder oppression claim?

Which Measure of Damages – Enterprise Value or Fair Market Value?

After *Rupe*, lawyers on both sides of shareholder oppression cases where the plaintiff is requesting a court-ordered buy-out must be concerned with the proper measure of damages. As demonstrated above, plaintiffs with enterprise value cases have far more valuable claims. Given the value of the company and the plaintiff's minority ownership interest, the question of whether enterprise value or fair market value applies could easily be a multi-million dollar question. So what guidelines, if any, does *Rupe* provide as to when a shareholder oppression claim deserves enterprise value or fair market value?

Unfortunately, the answer is not entirely clear, but *Rupe* does provide three important guideposts for determining whether enterprise value or fair market value is the proper measure of damages. **First**, the Dallas Court of Appeals appears to have rejected that minority and marketability discounts should never apply to shareholder oppression cases. Minority shareholder advocates – especially Professor Douglas K. Moll – have argued persuasively that "[m]inority and marketability discounts have no place in shareholder oppression disputes." *Moll*, 54 Duke L.J. at 318 & 319-383. By discussing Professor Moll's article and still holding that minority and marketability discounts apply, *Rupe* signals that there is no *per se* rule in Texas that these discounts never apply to shareholder oppression claims.

Second, lawyers should focus on the bad acts the plaintiff is asking the trial court to remedy. In *Rupe*, the Dallas Court of Appeals strictly tied the conduct Rupe had complained of (RIC's refusal to permit Rupe to market the Stock publicly to third-parties) to the proper measure of damages (fair market value). If RIC had permitted Rupe to market the Stock to third-parties, the appellate court reasoned that potential buyers would pay a purchase price that reflected fair market value and included minority and marketability discounts. At least to the extent that the plaintiff is simply seeking to sell their stock to third-parties, *Rupe* compels that fair market value applies.

Third, *Rupe* provides guidance on the types of cases that suggest enterprise valuation. *Rupe* found that enterprise value may be appropriate where the minority shareholder was not looking to sell or dissented from a potential sale – *i.e.*, situations where fair market value is inappropriate because there is no willing seller, under no compulsion to sell. *Rupe*, 339 S.W.3d at 301 (citing *Swope v. Siegel-Robert, Inc.*, 243 F.3d 486, 492-93 (8th Cir. 2001)).

[2] Whether these discounts should apply at all is beyond the scope of this article, but is well-addressed in Professor Moll's article. *See* Moll, *Shareholder Oppression and "Fair Value,"* 54 Duke L.J. at 318-366.

In many shareholder oppression cases, enterprise value will be appropriate because the minority shareholder was not looking to sell her stock – she simply had no choice but to seek a buy-out to remedy the majority shareholder's bad acts. Typical shareholder oppression cases – such as a squeeze out or freeze out, where the majority denies the minority of any current return on their investment, or conversion cases where the majority transfers the assets of the shared company to a new corporation owned solely by the majority – are not subject to fair market value under *Rupe* because the majority is compelling the minority to sell.

Although *Rupe* does not create bright lines for when enterprise value or fair market value will apply, it contains three guideposts that are instructive to lawyers and trial courts. Because the measure of damages for some court-ordered buy-outs remains uncertain after *Rupe*, lawyers should know the proper way to calculate the fair market value of minority stock in a closely-held corporation.

Calculating Fair Market Value of Minority Stock

Even before *Rupe*, the question of whether enterprise value or fair market value applied was hotly contested in many shareholder oppression cases. After *Rupe*, properly calculating the fair market value of minority stock deserves greater scrutiny because there is now some case law to support (or contradict) expert opinions on the proper valuation of minority stock interests. These valuation questions are incredibly important. For plaintiffs, the value may determine whether a lawyer can or will take the case on contingency. For defendants, the value may determine the size of a buy-out offer that could avoid litigation altogether. And for all parties, the question of whether fair market value applies to the court-ordered buy-out – and how that fair market value is calculated – is essential to making informed decisions during settlement negotiations.

After *Rupe*, this author has two main pieces of advice. First, leave the math to the experts. The prospect of applying the minority and marketability discounts has added levels of complexity to already difficult questions of business valuation. While many business owners (minority and majority) believe they can accurately value their own companies, it is unlikely that either the plaintiff or defendant is qualified to render opinions regarding whether discounts should apply and, if so, the amount of these discounts. After *Rupe*, parties who intend to proceed without valuation experts do so at their own peril.

Second, lawyers should be wary of the common error of combining the minority and marketability discounts. Because much of the buy-out negotiations in closely-held corporations occur without the aid of valuation experts and before lawyers are involved, calculation errors are common. One of the most common errors concerns the combination of the minority and marketability discounts. Instead of applying the discounts sequentially, a shareholder will combine the two discounts into one large discount, which substantially undervalues the minority stock. Take the situation discussed earlier – a company with $10 million enterprise value, a minority shareholder with a 10% ($1 million) stake in the company, a minority discount of 30%, and a marketability discount of 35%.

When the discounts are applied sequentially, the fair market value of the stock is $455,000. If the discounts are applied in combination, the supposed fair market value is $350,000 – a difference that undervalues the stock by nearly 25%. Moreover, a valuation expert may opine that it is proper to use a combined discount, but only if the total discount is reduced. For example, adding the minority and marketability discounts yields a total discount of 65%. But a valuation expert may opine that, when combined, the two discounts are actually lower. If a valuation expert opined that the combined discounts total 40%, for example, the fair market value of the stock in our hypothetical is $600,000 – or $250,000 more than if the discounts had simply been combined and $145,000 more than if the discounts were added and applied sequentially.

Because the prospect of applying minority and marketability discounts will have a material effect on the plaintiff's damages model for a court-ordered buy-out, parties should rely on qualified valuation professionals to render opinions about, and conduct calculations of, fair market value. Plaintiff's lawyers, however, must also determine whether a court-ordered buy-out is the best remedy for their minority shareholder.

Does The Plaintiff Have Options Other Than a Buy-Out?

For plaintiff's lawyers, it is important to remember that *Rupe's* holding is limited to court-ordered buy-outs. When considering *Rupe's* impact on a client's case, the lawyer must also consider whether another remedy may provide the client with a greater (or better) recovery than a court-ordered buy-out at fair market value. While a court-ordered buy-out may provide a client with an immediate financial recovery, it also terminates the plaintiff's ownership in the company. Thus, plaintiff's lawyers should explore at least three other potential remedies. First, if the plaintiff's complaint is a procedural one, explore a procedural remedy. If the plaintiff complains about the right to vote or attend meetings, or if there is a deadlock on the board of directors, consider whether a court-ordered buy-out is preferable to simply asking the trial court to cure the procedural problems. Second, if the company has stockpiled cash, consider suing for a court-ordered dividend, which would provide the plaintiff with an immediate cash return without sacrificing ownership in the company. Third, consider whether liquidating the company or appointing a receiver will provide a better economic return for the plaintiff. Although this is the most severe remedy for shareholder oppression, if the majority shareholder's fraud is pervasive and destructive, the client may benefit the most from simply dissolving or selling the corporation and distributing its assets.

The story of *Rupe* is not over yet – the Texas Supreme Court may still have something to say on the liability and damages questions raised by this groundbreaking case. Regardless of its ultimate outcome, *Rupe* has started a critical discussion on how to value minority stock interests in Texas shareholder oppression cases. This article is only part of that discussion, but raises four critical issues that all lawyers – litigators and corporate lawyers alike – should consider when advising clients in shareholder oppression disputes. ■